Keynote Address

2009 CNS Partnership Conference

By Robert Crandall, former Chairman and CEO of American Airlines Cargo

The theme of your conference – Implementing the Vision – sounds like a challenge appropriate for the airline industry; if only it could do so!

Although I have never seen a vision statement for the industry, I assume that if there were one it would include fewer crisis, consistent profits, better labor-management relations, more on time flights, fewer customer complaints and less general disapprobation.

It's astounding how elusive that simple set of objectives has been. I've been in and around the business for almost 40 years now, and I can remember few times when some crisis or the other wasn't stalking the industry. Way back in 1973, when I joined American from TWA, the then senior vice president of operations was in the elevator lobby as I disembarked, and asked if I knew what a mess I was getting myself into. And it's been like that ever since.

Indeed, it's been like that forever in commercial aviation. In the years since the Wright Brothers first flew, the airlines have never been able to ear consistent returns and have lost cumulatively, billions of dollars. In the years since the industry was deregulated, 200 odd airlines have come and gone, and most of our domestic carriers have been in and out of bankruptcy at least once; some have made the trip on multiple occasions. The consequences for the U.S. carriers, and our economy, have been very adverse.

Ironically, it was only a year or so ago when the industry looked to be building momentum for a successful year. Frightened by the very sharp fuel oil price run up in late 2007 and early 2008, U.S. Airlines – soon followed by the International carriers – embarked on the most widespread and successful program of capacity reduction in the industry's history. Their efforts were buttressed by a dramatic drop in fuel prices, which accelerated cost reductions well beyond early expectations. More or less simultaneously, the carriers began to unbundle their products, and in the intervening months have begun to realize substantial amounts of revenue from fees of various kinds, including baggage fees, fees for preferred seating, fees for paper tickets, fees for virtually everything but breathing on board. Ryan Air has even floated the idea of a fee for using the lavs!

All to no avail. In recent months, the progress of the prior year has been overtaken by the impact of the worst recession since the 1930's, and both traffic and revenue have fallen precipitously – with more bad news ahead. Morgan Stanley's latest forecast is that industry revenues will decline 16% in 2009, with international revenues down slightly more than domestic. In the months ahead, domestic capacity will continue to decline, and international capacity reductions seem likely to accelerate as airlines in every geography respond more aggressively to falling traffic and lower revenues. Giovanni Bisignani, Director General of IATA and an old friend from his days as chief executive of Alitalia, characterizes the industry as being in a period of "intensive care."

And as if all that isn't bad enough, half of the world is worried about getting Swine Flu – and the Vice President of the United States recently took to the airwaves to urge everyone to avoid traveling by air. Holy Smoke!

Perhaps worst of all, the impact of the economic slowdown seems likely to linger for some time. The FAA's recently published annual aviation forecast anticipates dramatically slower growth than previously expected. Instead of doubling between 2008 and 2025, the FAA now thinks U.S. aircraft movements will increase by only 50%, a huge reduction which bodes well for both the industry and the economy.

As we all know, today's airline industry bears little resemblance to the business of 20 years ago. In the United States, low cost carriers have proliferated, and claim an ever increasing share of traffic and operations. Moreover, the legacy carriers have dramatically cut costs, in large part by eliminating service features long taken for granted and adopting business strategies which mimic those of their low cost protagonists. In Europe and Asia, low cost airlines have also become far more important, although their impact on incumbents has been more limited than in the U.S. As a consequence of more fully developed transportation planning which has protected incumbent airlines in various ways. Despite these efforts to adapt to a constantly changing business environment, the airline industry has been unable to implement its vision – and continues to search for solutions.

These days, the solution du jour seems to be consolidation, via either mergers or international alliances. Many voices clamor that it is both inevitable and imperative.

Personally, I do not find the arguments in favor of mergers persuasive. Mergers will not lower fuel prices or increase economies of scale for already sizeable airlines. Effective implementation of mergers requires major capital expenditures and in most cases, increases unit labor costs. Finally, mergers inevitably disadvantage many employees, whose incentive to provide good service is thus further reduced.

Nor am I a fan of International Alliances. As many of you know, Jim Oberstar – Chairman of the House Transportation and Infrastructure Committee – has recently raised questions as to whether the international alliances already approved – and the anti-trust immunity they have been granted – have been beneficial to consumers and competition. I think the answer is that they have not. While the alliances have not been a major factor in the cargo business, they have clearly had the effect of limiting competition in the international passenger markets where they operate. Moreover, since alliances inevitably add overhead to the operational cost of the participating airlines, and add no functionality not achievable by the interline system of years ago, I simply don't see any purpose other than to expand the breadth of networks and thereby reduce competition.

If consolidation were really the answer, it is conceivable that a national system – in the United States, for example – could be run by a single efficient operator. However, consumers clearly benefit from the existence of multiple airlines; the absence of alternatives does not encourage good customer service.

Given the never ending trials of the industry, it may be that limiting competition in one way or another is the only way in which airlines can ever earn the returns needed to finance the large capital expenditures which air transport requires. However, it seems to me that the goal of national transportation planning should be to harness competition and regulation to create a system responsive to both the imperative of efficiency and the desirability of decent service.

As I have already noted, some governments have taken that reality into at least partially into account, and in a variety of ways, have sought to preserve the benefits of the legacy system while opening the way for new – in most cases low cost – participants to offer services to those who do not need optimal convenience or location. In the United States, however, we have neither conceived nor articulated any sort of national transportation plan and are thus continuously in the grip of whatever ad hoc analysis seems attractive at the moment.

As is always the case, "Victory has many fathers, but failure is an orphan" and no one wants to take credit for the sad state of the U.S. Aviation industry. Fortunately, there is plenty of blame to go around. In my view, the industry's problems reflect several shortcomings:

- *First and foremost is the reality that unfettered competition just doesn't work very well in certain industries. Like it or not, experience suggests that airlines look and are more like utilities than ordinary businesses.*
- *Second, the U.S. has failed to develop a national transportation plan of any kind and has thus been indifferent to the continuing decline of our highways, our railroads and our airlines.*

- *And third, our government has failed to invest in the capabilities and resources which only it can provide, most notably by failing to implement the new air traffic control system that everyone agrees we desperately need.*

Let me touch briefly on all three problems, starting with deregulation.

There are, as I am sure you know, many schools of thought on the success of deregulation. To me, it is clear that experience has validated the objections that myself and other articulated during the hearings in 1977 and 78 and has demonstrated that market forces alone cannot and will not produce a satisfactory airline industry, which clearly needs some help to solve its pricing, cost and operating problems.

The industry's single greatest problem is its inability to price its products to recover costs. As you all know, airlines work with a very distorted supply-demand equation. The instant perishability of empty seats – and the empty belly positions – the impossibility of quickly reducing fixed and semi-variable costs when demand falters, the public's view that all airlines offer an interchangeable commodity, the plethora of competitors and the desire to protect the reach of networks all create a great temptation to sustain volume by selling seats – and space – too cheaply.

An example of the absurd lengths to which price competition has been extended was visible on a recent day when it cost more to ship two bags from Chicago to Minneapolis than it cost to fly. The fare – just $88 – works out to just 3.3 cents per mile, or about a third of what it would cost to drive if gasoline cost $2.00 per gallon.

But pricing is not the only serious problem the industry has been unable to resolve. Airlines continue to schedule more flights into some airports than runways and facilities can handle, thus fostering persistent and often substantial delays. The Railway Labor Act, designed to foster more amicable labor-management relationships, has proven inadequate to the task in the airline business, whose labor relations have been persistently adversarial. U.S. Bankruptcy laws, intended to assume the equitable adjudication of creditor claims, have had the effect of regularly resuscitating failed carriers, this exacerbating the industry's tendency towards below cost pricing. And insufficiently demanding certification standards have encouraged a seemingly endless stream of hopeful entrepreneurs to try their hand at teaching established companies how airlines should be run.

Any and all who advocate greater oversight and some level of rational planning are routinely and roundly denounced as re-regulators. However, a program incorporating a national aviation plan and oversight adequate to deal with such things as slot controls at congested airports, more stringent standards for new carriers, revised labor laws and revised bankruptcy statutes is a far cry from imposing the inclusive regulatory regime of C.A.B. days. But these modest steps – in my view – would have a dramatic and favorable impact on the financial health of our airlines, the usefulness of our airlines system, service levels in the airline business and the welfare of airline employees.

Additionally, and despite the undisputed importance of aviation to the health and vigor of our economy, the U.S. has failed to invest in the facilities and systems needed to assure its continued growth.

A comprehensive redesign of the Air Traffic Control system has been the subject, since 2003, of an intensive planning effort under the guidance of the Joint Planning and Development Office, commonly referred to as the JPDO. Despite the acknowledged importance of the task – the U.S. Chamber of Commerce has called our failure to address the problem "devastating" – implementation of the system has been hampered by resistance from the Air Traffic Controllers Union, the unwillingness of some to invest in the necessary on board equipment, the unavailability of capital funding, ongoing arguments about who should pay how much to build and use the system, faulty management of various projects by the FAA and by political resistance from Congress, which is unwilling to support the facility consolidations essential to realizing the plan's economic benefits.

Unhappily, neither greater oversight nor a robust initiative to fix the air traffic control system seems likely in the near term. In my view, the die has been cast, and the United States is unlikely to impose any level of regulatory planning in the near future.

Moreover, the international alliances are now so firmly established that neither Jim Oberstar's review nor my disapproval is likely to impact their continuance. As a consequence, since unrestricted competition is unlikely to work better in the future than it has to this point, I think we will see more mergers, and an expansion of the international alliances, in the years ahead. However, the change will be gradual and as a consequence, I think the best we can hope for team term is that the U.S. carriers, and their international counterparts, will muddle through their present and future difficulties.

It's a fair bet that recession or not, people will continue to travel, although I think it will be some years before we see passenger volumes equal to those of last year.

As to the economy, my view tends to be half empty rather than half full. I think the recession will be deeper and longer than the optimists expect, which means that the airlines will see fewer business travelers and lower yields than they would prefer for some time to come.

It is also likely, I think, that air cargo volumes will remain depressed for some time to come. The precipitous traffic declines of late 2008 and early 2009 are greater than the effect on air cargo volumes following the tragedy of 9/11 when the aviation system was shut down. Even if world trade levels off in the near term future, and manufacturing activity increases following the substantial inventory liquidations that have characterized recent months, air freight volumes are unlikely to leap back to earlier levels. As we all know, consumer products tend to be high value and low weight and are an important component of air freight volume. Unhappily, U.S. consumer spending is unlikely to be robust in the near term, since U.S. consumers must substantially increase their saving to pay down debt and build nest eggs for the future.

In the context of this discouraging outlook, I think it is very important that the industry do all it can to optimize its performance and eliminate unnecessary costs. One of the most daunting challenges to achieving that objective is the pending impact of 100% screening of all cargo on passenger aircraft, scheduled for implementation only 15 months from now. While some believe that the many obstacles to accomplishing the goal make deferral likely, I do not think that counting on it is a sound business plan, since it would take only one single event to make deferral politically impossible.

Thus it seems to me that everyone in the cargo supply chain ought to be working hard to achieve compliance. As I am sure you know, only about 300 cargo screening sites have been certified by the TSA under its CCSP program, which means that lots of shippers and forwarders are not yet on board. Given the prohibitive cost of unpacking containers and pallets for individualized inspection at airports, and the lengthy delays such screening would inevitably cause, it seems to me that the industry should be working this problem more aggressively than it is.

In addition to becoming certified, forwarders should be pushing their important customers to achieve certification as well. Shippers, forwarders and airlines should also be pushing the TSA to certify one or more of the container and pallet screening systems now coming into use abroad. Finally, all hands should be collaborating to create on airport cargo screening facilities with optimized work flows and the best available support systems.

It's also time, it seems to me, to get serious about the paper problem. Way back in the 90's, before I retired, we were working hard on ways to reduce the imposing paperwork burden with which air freight has long contended. It always seemed to me – and must still seem to you – that the volume of paper is entirely disproportionate to either the value or the volume of the cargo itself.

Yet despite the lapse of more than a decade, it seems that only modest progress has been made. IATA's e-Freight initiative can manage only 12 of the roughly 30 documents required for each air freight shipment, and is functional at only 26 airports worldwide. In the United States, only two airports – New

York and Chicago – are current participants and the United States has no cohesive electronics system for managing the information associated with air freight exports.

In a world which has digitized virtually everything that has ever been learned, and is able to transit and receive almost anything to virtually any location on the planet, it is absurd for the airlines and their customers to be filling in forms and entrusting tote bags of documents to messengers who stand in line to tell bureaucrats what's arriving and leaving by air. In this area, as with security, the industry needs to be lots more aggressive. Air commerce is hugely important to almost every country, and the shippers, forwarders and airlines who make it happen have the clout needed to move the ball forward. Since I'm no longer in the fray day to day, I don't know why progress has lagged so badly – but I'm sure that whatever the obstacles, you should be pushing the World Customs Organization to get on with the task of standardizing the form and content of all the data fields and all the documents associated with moving goods from place to place.

Finally, of course, the industry needs to recognize that in hard times, customers will be even more anxious than normal to assure themselves that what they ship will be flown and delivered as promised. And airlines and forwarders alike need to understand that outstanding service is the best guarantee of continuing success.

You should also bear in mind that great service is a lots better differentiator in your business than a lower price. In the passenger business, a delayed flight, a surly agent or a disagreeable flight attendant is likely to be written as anecdotal, and is less likely to have a lasting impact than a delayed shipment which damages a customer's reputation or ruins a quarter's financials.

The passenger business is always in the grip of its dumbest competitor – that is, it is always subject to the whims of whatever marketing department believes that cutting prices will somehow shift enough market share, or create enough new demand, to make up for revenue lost. In your business, cutting costs below the level required to provide excellent service, and trying to buy back the business lost with lower prices, is almost certainly a losing proposition since you deal with recurring customers whose own business depends on your excellence. Of course you may still be the victim of someone who thinks it's better to cover variable costs and ignore fixed costs – but the laws of economics make it likely that person won't be around for too long. So, to some extent, you may have a bit of protection from the level of dumbness exhibited by the passenger pricing experts. Let's all hope so.

If you can make progress on all three fronts – efficiently managing greater security, reducing the paperwork burden and increasing the quality of your product – you'll have made great progress toward implementing the vision of becoming an even greater contributor of the world's economic progress.