Air Sickness: Who’s to Blame? (Part 1)

By Ivan G. Osorio

Summary: Business travelers, family visitors, tourists—all are affected by the airline industry’s woes. But who knows what really caused the problems in the first place? Industry expert and former pilot Vaughn Cordle blames management-labor relations for preventing fair competition. Next month: a closer look at how unions have harmed airlines.

A specter is haunting America’s airline industry: It’s the ghost of Eastern Airlines. Once one of America’s largest carriers, Eastern went out of business in 1991 following a prolonged, crippling and acrimonious strike. The episode was a nadir for labor relations in the airline industry.

Even if things are not quite as bad now as then, serious problems are weakening America’s major airlines—and causing some to contemplate Eastern’s fate.

Vaughn Cordle, a leading aviation consultant and veteran of the airline industry, puts much of the blame on the organization of the industry’s labor force. In an interview with Labor Watch (see article at right), Cordle explains that the industry’s current labor relations regime is unsustainable in the long term. Unions cannot continue to call the shots by threatening to shut down the airlines. Unless things change, Eastern’s ghost could come back to haunt the airline industry.

Airlines on the Brink

The terrorist attacks of September 11, 2001 were a disaster for the nation, but they struck the airline industry with a vengeance, pushing some already struggling

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A Tale of Two Airlines

In recent years, two airlines have become synonymous with instability and labor trouble: US Airways and United. Both are in bankruptcy, from which they hope to emerge this year. Both have cut costs considerably, but still face hurdles, including soaring fuel prices—up 42 percent during 2004, according to Forbes. And both face an uncertain labor situation: their unions’ response to their bad fortune has oscillated between cooperation and resistance.

US Airways, the nation’s seventh-largest airline, has struggled for years. It filed for bankruptcy in August 2002 and emerged from it in March 2003, after reducing its annual costs by $1.9 billion—with 36 percent fewer employees, 30 percent fewer available seats, and 25 percent fewer flights. It also got a $900 million federal loan guarantee. But last September, US Airways filed for bankruptcy again. It posted losses of $611 million for 2004, and $134.4 million for January and February 2005.

US Airways has gotten help in the form of subsidiary regional airlines: Appleton, Wisconsin-based Air Wisconsin Airlines and Indianapolis-based Republic Airways. They pledged to invest $125 million each into US Airways, under agreements that give each regional carrier three seats on US Airways board of directors and the right to own 19 to 25 percent of US Airways stock. US Airways says it needs $250 million before it can emerge from bankruptcy by June 30, a deadline set by its biggest creditor, GE Capital.

Failure to meet the June deadline could prompt GE to seek the return of US Airways’ planes. Can the airline meet the June 30 deadline? It will be a close call. On March 31, a federal bankruptcy judge extended US Airways’ deadline to file a reorganization plan by two months to May 31.

United’s troubles go back even further. Animosity between United, the nation’s second-largest carrier, and its unions dates back to 1985, when pilots went on strike for 29 days to protest a proposed two-tiered wage structure intended to bring down labor costs by bringing in new hires at lower wage rates. United managed to hire replacement workers and got some of its pilots to cross the picket line, but the company lost millions of dollars. The airline ended the strike by agreeing to pare down the two-tier plan so that it only applied to the first five years of new pilots’ employment.

The strike enhanced the clout of United’s already-powerful union. United’s employee-ownership plan, enacted in 1994, gave the Airline Pilots Association and the International Association of Machinists influence over more than half of the seats on United’s board of directors. The unions used their power to extract generous concessions when the airline, facing greater competition, could least afford them.

In the months following the May 2000 announcement of a proposed merger with US Airways, United experienced one of
the worst slowdowns in airline history, which forced the cancellation of 23,000 flights. United pilots opposed the merger, fearing they would lose seniority to US Airways pilots just as their contract was expiring.

The unions’ spending demands and stubbornness took its toll. Along with the lower demand for United’s once-profitable West Coast routes—the dot-com bubble had burst—United ended up losing $600 million in the first half of 2001.

Then came September 11th, in which terrorists used two United planes as missiles. In the five months following the attacks, United traffic declined by 25 percent.

United filed for Chapter 11 bankruptcy protection in December 2002, after posting 2001 losses of $2.1 billion and 2002 losses of $3.2 billion. Since entering Chapter 11, United has cut $5 billion in costs but remains in trouble, posting losses of $1.6 billion for 2004 and $326 million for January 2005. The airline says it needs to secure $725 million in annual labor savings to emerge from bankruptcy.

Who Pays?

Why should the average American care about the fate of US Airways and United? There are other airlines; and inefficient and wasteful businesses go under all the time—that’s the market at work.

Most other businesses, however, are not deemed “too big to fail” by the federal government, which has stepped in to save these tottering behemoths at taxpayer expense. The federal government has relieved US Airways and United of billions of dollars in pension obligations—which the legacy carriers took on during the era of generous union contracts.

Next month Labor Watch will look in depth at the many ways labor unions affect airline financial stability. By understanding why the airline industry is in deep trouble, we can decide whether the American taxpayer should bail out the industry.

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airlines like Southwest, JetBlue and AirTran. Being older means having older employees, expensive post-retirement health care costs and defined-benefit pension plans. United, as an example, has approximately 60,000 retirees supported by 60,000 working employees. A 74-year-old company is more expensive than a 35- or 5-year-old company. Because legacy airlines have higher costs, more leveraged balance sheets and lower productivity—in both assets and people—they have grown at a slower rate than the lower-cost air-

routes with human capital. How do labor rules affect the airline industry’s network operations and cost structures?

Cordle: Collective bargaining agreements (CBAs) impact every aspect of airline operation—pricing, scheduling, aircraft purchases, training, everything. Labor constraints and the inability to adapt to a changing environment prevent the legacies from transforming the business in a way that allows it to earn its cost of capital over a full business cycle. It takes a bankruptcy or the threat of bankruptcy to force the unions to agree to productivity and wage improvements. For example, United’s head count per aircraft fell from over 170 to around 120 since they filed bankruptcy. The fact that they did not change the business model signifi-
Union contracts can run hundreds of pages, and the work rules can result in a company that simply cannot compete with new, younger competitors. United’s Air Line Pilots Association (ALPA) unit had a labor agreement that ran 600 pages, compared to JetBlue’s 18-page contract with its pilots. JetBlue’s 12-year pay rate for captains is pretty good; however, they don’t have 12-year captains, and this allows them a cost advantage over an airline that has the majority of their pilots with greater than 12-year seniority. JetBlue is more productive, flying aircraft 13 hours a day versus nine for a typical legacy airline. Point-to-point airlines have higher utilization of aircraft and crews than a hub-and-spoke airline, but the hub airlines have scale economies that allow higher load factors and a revenue premium.

**LW:** Some policy commentators compare union management to an entrenched oligarchy whose only goal is its own survival. Is this a fair characterization of how unions operate within the airline industry? Do unions face the same sort of public-choice problems that affect government agencies?

**Cordle:** Labor union leaders measure performance in head-count-times-wages-and-benefit terms. This labor value proposition is in contrast to the airlines’ need to maximize firm value for the owners of the assets—the shareholders. This type of proposition is not workable, at least over the long run, in a market economy. The airlines with the most powerful unions have had the worst productivity, highest costs and most over-leveraged balance sheets. National unions have national agendas, but the local union units determine their members’ needs. It’s a political hierarchy and the union activist who is perceived to be the toughest on management tends to win the leadership position.

**LW:** The airline industry is characterized by high fixed costs and declining average costs. A union strike analyzes the physical capital and makes it unproductive, much like how a grocery strike can be very costly in terms of rotting food. Is this operational cost leverage a major source of unions’ bargaining power? Is this one reason why the airlines are so heavily unionized or are there other more significant reasons?

**Cordle:** Airlines are the perfect companies to be unionized. Employees like pilots and mechanics have specialized skills and are hard to replace in the short run. They can easily cause enough financial pain during negotiations to have the upper hand. Management then has no choice but to cave, because the costs from disruption in operations can easily exceed the costs of the new contracts. The high fixed costs are a function of not retaining enough earnings in the past, which is a function of labor taking more than its fair share, as related to industry averages and shareholder returns.

Interest costs on debt and operating lease costs are significantly higher at the legacies than at the LCCs. For example, Southwest’s interest costs per available seat-mile costs are one-fifth that of Delta’s and one-third that of the legacies as a group. Southwest has had below-industry average labor costs—in all its forms—over the last 35 years and this is why they have $5.5 billion of equity, which is 50 percent of their total assets. United, by contrast, has a negative $7.9 billion in equity.

**LW:** In October 2000, United agreed to pilot salary increases ranging from 21 to 28 percent. In December 2002, the company filed for bankruptcy. This year the Pension Benefit Guaranty Corp. took over the pensions of United’s 36,000 mechanics and baggage handlers, relieving the airline of millions of dollars in obligations to the under-funded plan. United is just one case study from the legacy airlines of a boom/bust cycle that persists in the industry. How can incentive structures be changed so that both management and unions stop taking short-sighted measures to address persistent problems?

**Cordle:** Southwest uses human resources as a competitive advantage. The employees are shareholders, and part of their total compensation is based on profit sharing and stock options. Management has an effective communications strategy, and this results in a superior culture. Southwest’s employees understand that their future security is a function of the airline’s success as a business. The legacies lost control of the communications process because they communicated through the union leadership. This resulted in a pathological mistrust of management because union leaders gain and keep their leadership positions by bashing management.

**LW:** A lot of current labor law dates from the New Deal and emphasizes economic stability. Yet today’s business climate is characterized by rapid technological innovation and global competition. How should the Railway Labor Act, which governs collective bargaining in the airline industry, be re-
formed to allow the industry to better adjust to rapidly changing economic conditions and secure its long-term health?

Cordle: Many, if not most, serious industry observers believe that the RLA should be scrapped. Bankruptcy laws and pension accounting should be reformed. The RLA is a problem because it allows the negotiation process to drag out much too long. Emotions get out of hand, and this leads to destructive behavior, and actually leads to labor contracts that are not sustainable over the longer term. Hence the inadequate buildup of equity and the aggressive accounting policies required to offset the non-competitive cost structures.

LW: There seems to be a pervasive lack of trust among airline management and unionized workers. Is this adversarial relationship an inevitable result of collective bargaining? Is there a better employer-employee relationship in airlines with a less unionized workforce?

Cordle: It goes beyond pervasive at many of the old-line network airlines. It’s pathological. The adversarial relationship is a function of the employees’ perception that greedy management is out to screw them. This perception is interesting because airline labor has been highly paid relative to other industries. There has been a revolving door of CEOs and senior management at the legacy airlines because of the underperformance of the industry and the below-market pay of airline executives. Legacy airline management has not been able to earn the cost of capital over the last three business cycles.

One major problem is the tendency of the industry to grow its capacity too fast for its own good. What’s completely irrational, in terms of capacity growth, at the individual airline level, is completely irrational at the industry level. Management wants to grow the airline as fast as possible for two primary reasons: 1) to spread high fixed costs over more seats, which lowers average unit costs, and 2) higher growth drives a higher share price. The result is that the industry has excessive capacity most of the time, and this is the primary reason fares have been falling significantly in real terms over the years. Other macroeconomic and industry fundamental forces are conspiring to prevent the industry from earning its cost of capital. Travel substitutes—e.g., low-cost technology for internet meetings and travel alternatives in the form of lower-cost LCCs—are reducing the revenue produced by legacy airlines. Business fares are 35 percent lower today than in 2000, and leisure fares are 35 percent lower.

The only way out, in terms of avoiding liquidation or bankruptcy in the short term, is outsourcing maintenance and other services. Labor unions are being forced to accept lower wages and benefits and longer working hours. The culture will be difficult to improve when labor has to work more for less; this is the challenge and dilemma for management. The unions that represent ground workers and mechanics have priced their members out of the market, and no management wants to face a union that will shut them down if their demands are not met. This is why the airlines are outsourcing as fast as they can.

LW: What should policy makers do?

Cordle: Government policy makers should think about the need for the United States to have a viable and worldwide competitive air transportation system. Economic logic suggests that the U.S. only needs perhaps three big network airlines, three big LCCs and a host of feeder airlines. Global alliances that carve up the world’s market may be the best way for the airlines to become viable business that can provide a normal, risk-adjusted, rate of return. They really are big portfolios of global airlines that are made up of sub-portfolios of airline and airline-related businesses. A good example would be alliances like Air France/KLM and Delta/Northwest, which eventually would be better managed and coordinated by a holding company. Delta is a national airline that has wholly owned regional airlines ComAir and ASA.

Currently there is no coherent set of transportation and government policies that would allow the industry to evolve into a viable transportation system. It most likely will take White House intervention to encourage the Justice Department to allow the industry consolidation that could allow a viable industry. Without consolidation, the network airlines will continue to be fragmented, feeble and non-competitive on a global playing field. Ultimately, the super-sized and stronger foreign airlines could displace U.S. airlines in the international markets. A case can be made that the nation and traveling public will benefit from a rationalized and consolidated industry.

The competitive dynamic can be maintained with the portfolio concept (i.e., holding company), since consolidation does not necessarily mean concentration. Consolidation is the least risky path for legacy airlines and it makes the most sense in terms of rationalizing a system that has too much capacity and too many hubs.

Deregulation has been a great success in terms of creating more jobs and lower prices. The government should declare victory and refocus its efforts on helping the industry return to a viable system that makes the most economic sense. Networks must be big to work, and they need to be competitive on a worldwide basis. This requires policy makers to expand their thinking beyond just jobs and prices.
Poll: Union Members Support Social Security Reform
Sixty percent of union members would choose a personal account option in Social Security if given that choice, according to a survey conducted on behalf of Americans for Tax Reform. Despite union efforts to defeat the Bush administration’s Social Security reform proposals, three out of four union members believe that Social Security is financially unsound, and 70 percent trust themselves more than their union, employer or government to manage their retirement planning.

Labor Department Increasing Union Audits
Union officials are grousin about the U.S. Department of Labor’s efforts to dramatically increase audits of labor union finances, including hiring 48 full-time auditors despite budget cuts elsewhere. AFL-CIO president John Sweeney told the New York Times that the move “is pure political payback for the labor movement’s opposition to the president’s antiworker policies.” But the Labor Department says it is only trying to restore its oversight to previous levels. Auditing of labor union finances declined significantly under the Clinton administration, from 1,080 in 1991 to 206 in 2000. By contrast, the Department completed more than 500 audits in 2004 and plans more this year.

Bush Administration, Republicans Unveil Labor Agenda
In a press conference last month with Congressional Republican leaders, U.S. Secretary of Labor Elaine Chao outlined an aggressive “job creation and retention” agenda based on President George W. Bush’s proposals for job training programs and community college education. (See Labor Watch, February 2005.) Highlights include:

- Consolidate all four major Labor Department state grant programs for job training and education, giving governors increased flexibility in exchange for tough performance standards. By the tenth year, states would be required to place 100 percent of trainees in new jobs.

- Develop accountability standards for federally funded adult basic education, literacy and vocational rehabilitation programs.

- Protect the religious hiring autonomy of faith-based organizations even when receiving federal grants for programs funded under the federal Workforce Investment Act.

Teamsters’ Hoffa Fires Embattled Aide
International Brotherhood of Teamsters president James P. Hoffa fired a top aide for the past six years amid allegations that he received more than $69,000 in improper pay, according to the National Legal and Policy Center. Carlow Scalf repaid the union but has admitted no wrongdoing. Last year, Scalf was blamed by the union’s former internal investigator for obstructing a probe of union connections to the mob in Chicago.

Wal-Mart Vice Chairman Accused of Anti-Union Activities
Two weeks after Wal-Mart Stores’ former vice chairman Tom Coughlin resigned amid a police investigation into expense account abuses, the United Food and Commercial Workers Union cited employees who claim Coughlin diverted thousands of dollars to pay union members to reveal the names of pro-union employees. A Wal-Mart internal investigation found money had been used for the benefit of individuals but not for anti-union activities. Coughlin said the funds were used for anti-union efforts on behalf of the company, but not illegal payments to union employees. A union spokesman admitted the union was unaware of staffers who received payments from Coughlin, even while the UFCW demanded that Wal-Mart release all documents related to Coughlin’s alleged activities.