COMPETITIVE PRACTICES: TRENDS TO WATCH

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The focus of this workshop is to identify long-term trends and developments affecting the future of air transportation. If you have worked on the commercial side during the past 20 years, you know that rapid and substantive change has been the norm. You also know that "long-term" often means next week. To be a forecaster in the airline industry, as I once was, requires a strong sense of humility, because the future so often follows neither the trend lines nor conventional wisdom. Thus, it is with both humility and presumption that I stand before you to share some developments and trends that I believe deserve your close attention as you try to figure out what the future holds. What are my qualifications for occupying this podium? I am neither an economist nor a futurist; I am just a former airline person. However, I have been both a participant in and a student of this industry for nearly 40 years, and maybe that is worth something. I must confess at the outset that I do not have many answers today, but I do have many questions for you to ponder. My comments will focus on four subjects: airplanes, pricing, alliances, and government policy.

Airplanes

Conventional wisdom holds that as time goes by, airplanes get bigger and they fly farther. And in recent weeks we have seen the rollout of the 767-400 and continued speculation about whether Airbus will build the A-3XX. You will not be surprised to learn that during the first 20 years of deregulation, the average stage length for U.S. airlines increased by 40 percent, from 503 to 703 miles. However, you may not have noticed what has happened to average seats per plane-mile during the same period. From 1978 to 1988 this indicator of average aircraft size increased from 146 seats per mile to 163—about what you would have expected. But in the past 10 years the average seats per mile fell back from 163 to 150. What caused this significant reversal in the trend line? What does it say for the future? Have the airlines lost sight of the relationship between plane-mile cost and seat-mile cost, namely, that as aircraft get larger, plane-mile costs go up, but seat-mile costs go down. Don't they realize that the combination of slot control, air traffic congestion, and the lower seat-mile costs of large aircraft mandate the use of bigger and bigger equipment? Or have they rediscovered the importance of frequency in preference to capacity? Are they now choosing fighters rather than bombers? If so, how long will this last? Recently British Airways announced its intention to replace its 747s with 777s in an effort to increase yield and lower costs. Does BA's decision signify the end of the airline industry's 25-year pursuit of revenue and market share? Will increased emphasis now be placed on profitability? Is BA the harbinger of an industry trend or merely an isolated exception? How do you reconcile BA's intentions with the reality of slot control at so many of the international airports it serves?

In August, United scheduled 21 daily nonstop roundtrips between Washington Dulles and Los Angeles and San Francisco. Just five of those roundtrips were flown with 747, 777, or 757 equipment. The other 16 roundtrips, or 76 percent of the total, were flown with A-320s and A-319s. Whatever happened to the old rule that once an airline has five or six flights in a long-haul market, it should increase the size of its aircraft rather than continue to add frequency?

Today's most interesting airplane development is, of course, the RJ—the regional jet. The plethora of RJ orders is reminiscent of the late 1980s, when Boeing had a five-year waiting list for its 757s and 737s. Is the RJ going to revolutionize the U.S. marketplace by bringing back linear routings and overflying the hubs? If so, what happens to the hubs? Or is the RJ merely a replacement for the consumer-unfriendly turboprops that have characterized the regional carriers' fleets? Will the pilots' unions find a way out of the mutually exclusive positions of demanding scope clauses at the majors while simultaneously trying to represent the best interests of their regional airline membership?

Will the regional carriers find the siren call of nonhub flying so attractive that they will be willing to cut the umbilical cord that now keeps them tightly tied to their major airline partners? Will they be frustrated to discover that slot control and/or lack of gates preclude service to the very destinations that medium-sized cities desire? Nonstop access to New York LaGuardia, Washington National, and Los Angeles is always at the top of these cities' wish lists. Will the price-conscious consumer be disappointed to learn that, despite the hype, the RJ is not a low seat-mile cost airplane making $69 fares possible throughout the country?

Is the current emphasis on smaller airplanes a real change in direction or merely a blip in a long-term trend line? And what is its significance for air traffic control, airport managers, airline fleet planners, and the airframe and engine manufacturers?

Pricing

Airline pricing in a deregulated marketplace is always complex and often irrational. Thus it defies generalizations. Nonetheless, I will plunge ahead. Let me start with my pet peeve. That is the use of yields as surrogates for prices by economists, by Wall Street, by the U.S. Department of Transportation (DOT), and, I'm sorry to say, by the airlines, which obviously know better. How many times have you and I been taught never to use averages to reach sweeping conclusions? But that is exactly what we do when we use

yields for a city-pair, an airport, or even an entire nation to prove that things are either wonderful or horrible. Please remember four warnings as you track yield trends. First, prices are set on great circle mileage, but yields are calculated using actual miles flown. Thus, the more circuity in the routing, the lower the yield. Second, air travel is segmented into two primary categories—the price-sensitive discretionary traveler chasing discount fares and the time-sensitive business traveler who is usually stuck with walk-up prices. There are no yield data today, nor will there be tomorrow, that can identify the varying proportion of discretionary versus business traffic that is included in the average.

The third warning stems from the DOT requirement that passengers using frequent flyer miles be included in the traffic and revenue statistics. Thus, as free travel increases as a percent of total, there is an accompanying downward pressure on yields. My fourth warning relates to negotiated fares for corporations, which we call the "managed" market. These corporate discounts are increasingly being established on a net basis, that is, without inclusion of travel agent commissions and overrides in the price. Think what impact this accelerating development has on reported yields. I'll now step down from my soapbox with a quiet plea to please be careful about the conclusions you draw from yields.

One universally accepted principle in the airline business is that the discretionary market is elastic and the business market is inelastic. It is this belief that underlies the Saturday night stay requirement that has been the hallmark of market segmentation since SuperSaver was introduced in 1977. Let's roll the clock back 22 years to the introduction of SuperSaver. This event was, of course, the development that unlocked discretionary travel in the U.S. market. It was also the development that allowed airlines to accommodate business and vacation travelers on the same airplane rather than on separate aircraft as is the case in Europe and much of the rest of the world.

In April 1977 the unrestricted walk-up, roundtrip coach fare in transcontinental markets was $412. The new low SuperSaver fares were set at $227 for midweek travel and $268 for the weekend. These prices represented discounts of 45 percent and 35 percent, respectively. Look how we have progressed in 22 years. Depending on the time of the year and the sale du jour, you can find a transcontinental roundtrip fare between $300 and $400. The roundtrip walk-up fare is now over $2,000 in some markets. When SuperSaver was introduced, the walk-up fare was less than twice the discount fare. Now, depending on the time of the year, it can be five or more times the discount fare. A large part of this increased spread between walk-up and discretionary pricing has taken place during the 1990s. It raises the question of just how far the airlines can push the inelastic portion of the market. Is there a point at which the fare differential becomes so absurd that business travel stagnates or declines—even without an economic recession? Are we beginning to see signs of this phenomenon in the most recent airline earnings reports?

I suggest that you monitor a little-noticed but important development with regard to fare regulations. This is the class-action lawsuit against airlines that prohibits travel agents from issuing hidden-city and back-to-back tickets. Without going into a lot of detail, these are the techniques used by business travelers to access low fares by buying one or more discount tickets and then throwing away unneeded coupons. Ending the airline prohibition of this practice was included in one of the consumer protection bills introduced in Congress earlier this year. Think of what could happen to the price of both walk-up and discount travel should the courts, or the Congress, or the DOT decide that passengers have a right to buy a ticket and then discard any part that they choose not to use. Think about it: what other industry dictates what consumers can do with a product or service once they have paid for it?

In a well-publicized development, the airlines are embracing the Internet with great enthusiasm. This action follows their success in reducing distribution costs by both cutting and capping travel agent commissions. Now they are taking their cost-reduction efforts a step further by trying to persuade passengers to book online at their proprietary websites. They are even offering special low fares that are only available at these sites. These actions have broken the long-held promise that the ticket price is the same whether purchased from a travel agent or from the airline directly. The airlines naturally aspire to shift as many passengers as possible to their websites, thereby saving both commissions and their own reservations costs. However, there is an obvious major impediment. Airline pricing is extremely complex and the average traveler cannot be expected to comprehend all the rules and restrictions. That is one of the big reasons they turn to travel agents. Could fare simplification be the key to getting 25 to 50 percent of bookings on airline websites? Are airlines analyzing whether distribution costs saved from online booking can outweigh the revenue maximization benefits derived from complex fare structures and sophisticated yield management systems? If you are an airline manager with responsibility for both revenues and costs—not just revenues—you should be asking yourself these questions.

Alliances

Is there anything else going on in the airline world today besides alliances? I sometimes think Aviation Daily should be renamed Code Share Daily! We are, of course, at the lemming stage with alliances. Conventional wisdom and Wall Street decree that every carrier has to be in one or die. Is it a trend or just a fad? No one knows. What we do know, however, is that it is a lot easier for a CEO to enter into an alliance than it is for the marketing department to make it work. There is little question that a properly structured, bilat-

eral, end-on-end alliance can mean significant financial revenue benefit to the partners—just look at Northwest and KLM. What is not at all clear yet is whether multilateral, worldwide alliances can offer the proverbial win-win result for more than two participants. What is clear, however, is that alliances—no matter what the benefits—are not a panacea for an airline that is suffering from uneconomic labor contracts or a bad fleet mix. In this regard it is somewhat pathetic to see the Greek government putting such a high priority on finding an alliance that will accept Olympic. That hardly seems the number one problem to be addressed.

We have all read the various press releases detailing the incremental revenue accruing to alliance participants. What we haven't seen yet is a press release that states: "Our alliance hasn't produced any new revenue." Or one that says: "We have lost millions of dollars in revenue to other carriers' alliances." The new joint fares offered by alliance partners have undoubtedly generated some new traffic for the industry, but how much? Isn't it likely that most of the so-called incremental revenue is coming at the expense of other carriers? Won't these losers now have to join an alliance strictly for defensive reasons?

It looks like there will be just four or five global alliances, each with five or more members. Is it reasonable to expect that each one of them, and each airline in each alliance, will be a winner? This is a key question because to be a participant in an alliance means that an airline must surrender some part of its sovereignty for the greater good of the alliance. I am not talking about coordinating frequent flier programs, operating at contiguous gates, or achieving the Holy Grail of "seamless connectivity." I am talking about the hard things—for instance, reallocating the aircraft resources of the alliance by having carriers pull down capacity in certain markets and increase it in others. How are such decisions going to be made? Will it be by unanimous or majority vote? Or will the big guys simply tell the little guys this is the way it is going to be? The governance issues with a bilateral alliance are challenging, to say the least. The governance issues in a multilateral alliance are truly mind-boggling.

Before an airline enters an alliance, it should be confident regarding the benefits that will accrue to it—from both an offensive and a defensive standpoint. And it should also be certain that it may not want to switch alliances in the future. The current situation facing Air Canada and the Star Alliance ought to make a number of carriers pause before committing too much of their autonomy to an alliance.

The continued evolution of alliances is something you need to monitor very closely as you assess the future. Are they going to be the cornerstone of the global airline market, or are they going to be little more than super frequent flier programs? There are two critical developments that could have a major impact on the future of alliances. First, what happens if DOT reverses itself on the subject of antitrust immunity? Second, what is the future of the alliance movement if governments change the current rules regarding foreign ownership? These two issues fall into the area of government policy, so let us move on to that.

Government Policy

I must tell you that the Transportation Research Board committee on which I recently served had major concerns regarding the way DOT has traded antitrust immunity for open skies agreements. We were not at all convinced that such a quid pro quo was in the best interest of the consumer. Does anyone other than American Airlines and British Airways believe that giving these two carriers immunity to set prices, schedules, and commissions in the New York-London market is a pro-competitive step—even if Heathrow is opened up somewhat?

With cross-border mergers and acquisitions taking place in so many industries, how long will it be before the prohibitions on foreign ownership of airlines are lifted—in the U.S. and throughout the world? Will the concept of flag carriers survive in the European Union, or will we see the type of consolidation that has taken place in the U.S. marketplace? Does the recently announced quasi-merger between Alitalia and KLM become the model for the future? And is a similar arrangement between Northwest and Continental in the offing? Will the ultimate shape of alliances mean that two or more carriers merge their general office, sales, reservations, and airport customer service functions but leave the pilots, flight attendants, and mechanics in separate operating companies?

Another key policy issue is slots. Few, if any, new airports will be built in major cities in our lifetimes. Nor will we see many new runways at most congested airports. This means that airport access restrictions will continue to be a challenge facing airlines and governments, even if all air traffic control constraints were to magically disappear. What are aviation authorities going to do to ensure that slots are assigned to those airlines that will use them to benefit the greatest number of consumers? In the U.S. slots are being hoarded and underutilized in order to protect grandfathered slot holders from competition. When I last checked, commuters were flying 31 percent of the slots at LaGuardia, substantially more than the 23 percent they have been allocated under the High Density Rule. Our TRB committee felt very strongly that it was past time for Congress and DOT to abandon the 30-year-old slot program and to replace it with a congestion pricing approach that promotes maximum competition at restricted-access airports.

A current hot policy issue in the U.S. is the one of controlling "predatory behavior"—the usual charge being an incumbent carrier flooding the market with low-fare seats in order to drive out a new entrant. Our committee didn't question that there had been some instances of aggressive behavior against new entrants. However, we had difficulty buying into the excessively regulatory solution being pro-

posed by DOT. In fact, we could not reach agreement on whether DOT should be dealing with alleged predatory practices at all. In my opinion—and I stress that this is not the committee's view—if DOT really wants to do something to level the playing field for new entrants, it should not try to regulate the pricing and scheduling responses of the incumbents. Rather it should focus its attention on frequent flier programs, commission overrides, gate access, slots, and the misuse of CRS information to discipline travel agents.

DOT tends to define the consumer as the price-sensitive discretionary traveler. It issues many statements touting the benefits to the economy from the spread of low-fare carriers. What it is actually talking about is the unique phenomenon known as Southwest. Southwest is everybody's darling, and rightfully so. It is like the Energizer bunny—it just keeps going, and going, and going. There are two developments to watch. First, will any new entrant be able to replicate Southwest's record of success—either in the U.S. or in Europe? Second, will the current airline-within-an-airline experiments at Delta, United, and US Airways be able to compete with Southwest, or will these experiments go the way of the B scale? Is the airline-within-an-airline concept the only solution to competing with Southwest? If so, how great a percent of the big carrier's operation can it become?

I cannot close without highlighting one other development to watch: the high-speed train. Just imagine the impact a bullet train could have on the problems of congested airspace, restricted airports, and scarce gates in the Boston-New York-Washington corridor. But don't hold your breath. After nearly 40 years of waiting for the bullet train, I have decided to take the Shuttle!