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Airline deregulation hits hard 25 years later

By Harry Levins, St. Louis Post-Dispatch
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Nov. 7--A year ago last week, St. Louis learned a lesson the hard way: airline deregulation giveth, and it taketh away.

Twenty-five years of deregulation had given passengers real bargains. But it hit the traditional airlines hard -- so hard that last Nov. 1, American Airlines axed half its flights from what had been a full hub at Lambert Field.

As economics Prof. Jan Brueckner of the University of Illinois puts it, "Deregulation's real bite is happening, a quarter of a century later."

That bite is drawing blood. The Air Transport Association says that in the three years starting in 2001, the industry lost more than $23 billion, with no letup in sight. "Losses this year will exceed $6 billion," association chief James C. May said in September.

Similarly, in another September speech, American Airlines chief Gerard Arpey called the industry "a universe in which I am starting to feel a bit like Luke Skywalker, battling every conceivable enemy."

In fact, Arpey must do battle with a parallel universe -- the low-cost airlines that threaten the traditional majors like American.

In effect, the deregulated airline industry has split into two industries.

The newer industry -- the low-cost airlines like Southwest -- makes a profit, or did until the price of oil shot up in recent months. (Indeed, even with the boost in oil prices, Southwest recently rang up its 54th straight profitable quarter.)

The older industry includes what insiders call "the legacy lines" -- airlines like American, United and Delta. Mostly, the legacies lose money by the planeload. They're caught in a crosswind of cannots: They cannot bring costs way down, but they cannot raise fares.

The result: United is in bankruptcy, and US Airways is in bankruptcy again. Others may well follow them into bankruptcy, with Delta the likeliest candidate. Some may go all the way to the graveyard, there to join such once-fabled legacies as TWA, Pan Am and Eastern.

Back in 1978, that was hardly what the people who pushed for deregulation had in mind.

Regulation lasted four decades, starting in 1938. That's when the government and the airlines struck a bargain.

The airlines let the government tell them which cities they could serve, and how much they could charge for tickets. In return, the government set the ticket prices high enough to make sure the airlines made money.

The bargain was a good deal for airline management. Without much sweat, management kept the books in the black.

The bargain was also a good deal for airline unions. They won high paychecks and fussy work rules. Management went along. After all, the government would cover the higher labor costs by raising ticket prices.

Trouble is, the bargain shut out consumers. Nobody could shop around for a discount fare. The airlines might compete on the basis of which had the leggiest young flight attendants, or the highest-octane cocktails. But they all charged the same fares.

And those fares were high -- so high that flying ferried only the coat-and-tie set. Business executives flew. The rest of us drove, rode the bus or took the train.

But in the '70s, a wave of deregulation washed across the land. Trucking got deregulated. Telephone service got deregulated. And in 1978, the government unleashed the airlines.

Now, airlines could fly wherever they wanted. They could compete on fares. New airlines could elbow their way into what had been a tight little club of legacies, and more than 30 did.

Most failed. (Remember People's Express?) They had just enough capital to buy a handful of old, hard-to-maintain planes. When they tried competing head-to-head against the legacies, they found their fares matched -- and their schedules outmatched.

The legacies also bought consumer loyalty with frequent-flyer programs. And they fought back by forging "hubs" at selected airports, like TWA's hub at Lambert Field.

At such a hub, waves of one airline's inbound planes would land within minutes of one another, surging in from outlying "spoke" cities.

In a big game of musical chairs, passengers from the "spoke" cities would get off their planes at the hub and transfer to planes bound for different "spoke" cities. Then, in another surge, the outbound planes would take off within minutes of one another.

Hubs meant full planes. Those full loads let the legacies fly to smaller cities that otherwise would see a lot less in the way of air service.

As Mel Burkart of Parks College at St. Louis University points out, before hubs, TWA could rarely fill a flight from St. Louis to, say, Columbus, Ohio.

"But with the hub, TWA could funnel into St. Louis people who wanted to go Columbus from places like Omaha and Memphis and other smaller markets," says Burkart, a former TWA pilot and a professor emeritus who has taught airline economics. "And that way, TWA could fill up a plane to Columbus."

What's more, hubs let legacies cut some fares. As long as the legacies covered their costs by filling their planes to a certain percentage, every extra seat they filled was so much gravy. Before long, fares for the same flight varied wildly.

Business travelers still paid full fare and flew at their own convenience. But for pleasure travelers who were willing to surrender some convenience, the legacies would whack fares. Suddenly, planes teemed with travelers from all walks of life.

Their presence proved that deregulation worked. In 1978, the nation's airlines carried a bit more than 250 million domestic passengers. By last year, that number had jumped to almost 600 million. And they flew at a bargain.

Spokesman Jack Evans of the Air Transport Association says, "Even in nominal terms, ticket prices are the same as they were 15 years ago. After you factor in inflation, they're cheaper than they were 15 years ago." In fact, when you factor in inflation, they're almost 50 percent cheaper than they were before deregulation.

But what's good for the consumer may yet prove to be poison for the legacy lines.

As an industry, the legacy airlines have some quirks that set them apart.

Like any service business (a restaurant, say, or a hotel), an airline needs a lot of workers. Like any high-tech business -- and a brand-new airliner is high-tech indeed -- an airline needs carloads of capital. So the industry has a double-edged drawback. It's both labor-intensive and capital-intensive.

The legacies look to expense-account travelers for most of their income. But business runs in cycles. In boom times, business travelers stack up at ticket counters. Conversely, when the economy sags, executives steer clear of the airport. Trouble is, an airline's fixed costs stick around. (Internally, airlines often wind up on the wrong side of the cycle. In boom times, they order costly new planes to handle the crunch. By the time the planes arrive, the boom has gone bust -- and the airlines have to park the planes.)

To an unusual degree, airlines live at the mercy of forces beyond their control -- the business cycle, for example. And the interest rates on all that capital. And disasters like 9/11 and the Asian SARS virus, both of which slashed travel. And now, the price of oil. Spokeswoman Jacquie Young says that this year, American Airlines "expects to spend over $1 billion more for fuel than we would with last year's already relatively high fuel prices."

The other airline industry -- the low-cost airlines -- also has some stand-apart characteristics.

Low-costs are generally free of the unionized legacy, with its large paychecks and restrictive work rules -- for example, rules barring part-time workers and split shifts. The low-costs' work forces are young and healthy, running up relatively little in health and pension benefits.

Most low-costs fly a single type of aircraft, like Southwest's all-Boeing 737 fleet. The legacies fly different models to serve different markets -- jumbo jets on long hauls, mini-jets on short hauls. The low-costs give up that flexibility. In return, they reap vast savings in maintenance and training.

The low-costs shun hubs in favor of point-to-point flights -- City A to City B and back. That way, their planes spend more time in the air and less time on the ground waiting for connecting passengers. A plane in the air makes money. A plane on the ground costs money.

In choosing which airports to serve, the low-cost lines focus on big cities -- the top 100 markets.

"If you're flying 150-seat aircraft, that's the only business model that works," says Northwest Airlines pilot Duane E. Woerth, president of the Air Line Pilots Association. "The United States has 429 airports with scheduled air service -- and Southwest serves only 60 of them. They'll never serve Waxahachie, Texas," population 18,168. "Their business model doesn't work in Waxahachie."

Low-costs like to fly into secondary airports, where doing business is cheaper. Unlike American, Southwest won't take you to Boston. But Southwest will take you near Boston -- to Manchester, N.H., or Providence, R.I. Passengers willing to drive into Boston from Manchester or Providence can fly at bargain rates.

Airline insiders measure traffic in passenger-miles. One passenger flown one mile equals one passenger-mile. Last year, on domestic routes, U.S. airline flew 499 billion passenger-miles.

To fly one passenger one mile, low-costs spend a few pennies less than a dime. Legacies spend a few pennies more than a dime. And when the passenger mileage totals 499 billion, those pennies add up at jet speed.

From Oregon, economics Prof. Richard Gitta of the University of Portland notes that thanks to low costs, Southwest can make money even when it prices a ticket below what US Airways must spend to fly the same passenger the same distance.

Gritta adds: "When US Airways cuts their fares to meet Southwest, they die."

To describe the cutthroat competition, McGill University economics Prof. Paul Dempsey uses a scientific scenario called "The Tragedy of the Commons."

In this scenario, 10 farmers who each own 10 cattle share a commons -- a pasture open to all. This commons has just enough grass and water to support 100 cattle.

But sooner or later, one farmer figures he has a lot more to gain than lose by adding an 11th cow to his herd -- and then a 12th, and then a 13th.

His profits spur the other farmers to boost their own herds. Individually, their decisions make sense. But as a bloc, the farmers soon ruin the commons by overgrazing.

"Airline economics are similar," says Dempsey, who has written several books on the topic. "What's individually rational behavior becomes collectively irrational."

Dempsey says all airlines have an incentive to add planes. That way, they can spread their fixed costs over more passengers. All's well -- until the business cycle sags. And then, says Dempsey, "the market is flooded with overcapacity."

To keep money coming in, the airlines cut ticket prices. But when the legacies cut, they bleed. Their prices fall short of their costs. Even so, they have no choice.

Time was when the legacies could shout about their cheap pleasure fares in full-page newspaper ads -- and at the same time jack up their business fares while telling nobody.

The Internet changed all that. "With the advent of the Internet, there's greater fare transparency," says the ATA's Evans. Thanks to Internet surfing, he says, "Consumers are used to getting the lowest fare possible."

As a result, the low-costs have muscled up their market share. Back in 1990, they flew six or seven of every 100 passengers. Now, they're flying anywhere from 21 to 26.

So the options for a legacy like US Airways are stark: Match Southwest's fares or fly empty planes. The result: In September, for the second time in two years, US Airways filed for bankruptcy.

The legacies are trying to cut their costs.

"There may be too many hubs," says Brueckner of the University of Illinois. The legacies seem to agree.

They're paring back some hubs, as American did by making St. Louis a regional, sort-of hub. Some legacies are axing a hub or two -- US Airways at Pittsburgh, Delta at Dallas-Fort Worth.

At hubs that survive, legacies are stretching those surges in traffic over longer periods to cut labor costs -- what American calls "a rolling hub." (Passengers pay the price of longer waits for connections.)

Legacies have gone to their unions time and again, with the same message: "Unless you work for less, you may not be working at all."

Legacies are packing their planes more tightly. Before deregulation, the airlines filled 61 percent of their domestic seats. Last year, the airlines filled 72.4 percent. But the ATA says the breakeven point was higher still -- 76.4 percent. Why so high? Because the tickets are cheaper and the seats more numerous.

Since deregulation, the airlines have boosted domestic capacity by 130 percent. The results: Too many seats chasing too few passengers.

People like Evans And Dempsey say that within a few years, the overcapacity problem could be solved the hard way -- by legacy "consolidation," their polite term for a legacy airline or two going belly-up.

But not all of the legacies. At the Aviation Institute of George Washington University, researcher George D. Novak thinks the market still has plenty of room for full-service, high-priced seats.

"I fly a lot," he says. "When somebody else is paying for my ticket, I go business class. On long-haul flights, there'll always be a market for service and comfort."

As for the current plight of the legacies, Novak says, "In the past, you'd have one major carrier on the brink. Now, all are facing a crisis. Very likely, we're at a turning point. But where it will go is anybody's guess."

In the long run, say Portland's Gritta and St. Louis University's Burkart, the low-cost airlines could gradually morph into semi-legacies as their fleets and their workers age.

Illinois' Brueckner says, "In the end, we'll see a mixture of low-cost, point-to-point airlines and network carriers that will look a lot different." And despite the turmoil, he says, "The consumer will be better off."

As Evans puts it, "Competition is good for the consumer" -- even when it's rough on the producer.

McGill's Dempsey calls the deregulation record "a very expensive and tumultuous experiment in free-market economics."

But Gritta says, "If you're an advocate of the free market, you have to let the industry go where it's going to go -- even though there's a lot of pain and suffering in the middle run."

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