



Aviation Roundtable

Back in profit, carriers battle bureaucracy, costs, competition with innovative ideas.

After several years of soaring costs and deep cost cutting, major U.S. airlines finally appear headed for blue skies, with the top six showing profits again. But it's been a rough ride. In the aftermath of 9/11, carriers have been hit by soaring costs from heightened security, exorbitant fuel prices and increased labor costs. For this year, however, analysts see more than a few bright spots on the horizon. Total profits are predicted to reach as high as \$6 billion, provided oil prices don't spiral upward again.

Geoff Botting talks with the regional heads of three carriers with regular flights to and from Japan: Theo Panagiotoulas, Managing Director, Pacific, American Airlines, Inc.; Charles M. Duncan, Managing Director, Continental Airlines, Inc., Japan; and Mark F. Schwab, Vice President, Pacific, United Airlines, Inc.

ACCJ Journal: Tourism has become the world's biggest industry. More and more people are traveling. So how did U.S. network airlines manage to lose money in such a seemingly lucrative market?

Theo Panagiotoulas: Just one word: fuel. When you've got your second-largest expense rising at the rate that it has been, it makes it very, very difficult to try to create some kind of sustainable profitability. The biggest challenge is dealing with this increase, which represents almost 30% of our total costs. Every time a gallon of fuel goes up by one cent, you're talking about incremental costs of \$33 million. We've introduced fuel surcharges to try to cover it, so some of that's been passed on to the consumer; but you can't do that extensively because sooner or later you're going to dampen demand.

But don't all of your competitors, including the low-cost carriers, have the same problem to contend with?

Charles Duncan: That's true. But if one financially sick carrier is willing to price at variable costs – just to cover the cash costs of crew and fuel but not the capital costs – we all get dragged down to that lower pricing point. One of the frustrating things for all of us is that the airlines tend to do very poorly financially – but, then, everyone around us in the value chain does very well. The airports, for example,

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Charles M. Duncan, Managing Director, Continental Airlines, Inc., Japan



Mark F. Schwab, Vice President, Pacific, United Airlines, Inc.

PHOTOGRAPHY FOR THE ACCJ JOURNAL BY HIDEHIKO UMEHARA AND MATTIAS WESTFALK

are very profitable. Airplane manufacturers, security companies and other vendors at the airports – they all make money. So fuel is key.

Mark Schwab: There is a story of how the airline business is doing in the rest of the world, and how it's doing in the U.S. For the last couple of years, the rest of the world has actually been turning pretty good profits. In the United States, we have competitive pressure from the low-cost carriers who have been growing and benefiting from fuel hedged at nearly half of what it is selling at today. Additionally, there's a situation in the U.S. where capacity tends to exceed demand, and we end up selling at the lowest price to stay competitive.

Your balance sheets have improved over the past year or so, with profits returning. Is this a sustainable trend? Or merely an immediate benefit from all that painful restructuring you've been carrying out?

Schwab: I'm sure it's sustainable. We're very focused on a performance agenda of controlling costs, optimizing revenues and improving our customers' experience. We have to be careful not to let costs creep up, but we believe by executing against this agenda, we'll be successful.

Now that your low-cost competitors have been around for many years, are they starting to inherit network-type costs, and thus becoming less of a competitive threat?

Duncan: The models are converging. Southwest Airlines is paying its employees more than all of us do. A pilot earns more per hour at Southwest than any other major airline in the U.S.

Panagiotoulas: We have many issues to deal with – the bureaucracy and the archaic systems – as we try to operate in a new environment. But a lot of those solutions have got to be focused on improving productivity.

The merger-mania talk has toned down recently. Even so, are mergers the future for the network carriers? Will we see fewer and larger U.S. carriers in the years ahead?

Schwab: We're one of the companies that have long been advocating that consolidation is necessary for sustaining the health of the future of the industry. The rationale is that we think there is still too much capacity in the U.S. market. In our industry, in 2005, almost 50% of U.S. airline capacity was in bankruptcy. That's not a healthy industry. So you have to ask the regulators: Do you want an industry that's limping along? Or do you want the industry to be sustainable to provide competitive jobs and a comprehensive transportation network that serves the entire country?

Duncan: Sure, our strength to move people is vitally important to commerce and trade.

Panagiotoulas: From the perspective of American Airlines [which has never sought Chapter 11 protection], we're looking at this as a stand-alone issue.

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We're a strong enough carrier. We have a strong enough network to move forward on our own, so our work is to concentrate on what we've been doing so very well during the last three or four years, and continue focusing on that. We don't have any particular interest at this point in planning mergers. Still, the landscape can change very quickly, and we will adapt accordingly.

Do you see your relatively high costs as a competitive disadvantage against foreign carriers, which often receive support from their governments? Does Washington view this as a trade issue, and would you want it treated as one?

Schwab: The point we make is that security costs have absolutely skyrocketed, and we get new regulations and requirements added in a fairly steady drumbeat, affecting aviation more than any other industry. Security is clearly very important; and, therefore, the government should step up to take a more active role and open its pocketbook to cover these additional security requirements. In Japan, for example, 50% of the security costs are shouldered by the government.

Duncan: And in the U.S., it's slapped on to the passenger in the form of a ticket tax or borne by the airline directly.

Panagiotoulas: Yet, there are plenty of examples around showing that, even with subsidies, some carriers are not successful. It goes beyond just the subsidy. It's about being able to offer a specific service, which is about efficiency, value, network, reliability. A lot of that can't be fixed with subsidies. Mark is exactly right – no carrier has been seeking subsidies. That's not the way forward. You need an open marketplace. Despite all of our challenges, this approach still provides more choice, stimulates the market and gives people the chance of traveling when they otherwise could not.

Duncan: The airline business in the U.S. does very well. We've been very efficient. All of us can compete very, very well against all of the Asian carriers or anywhere else in the world. We tend to be very lean, very mean. A lot of other carriers aren't ready to compete with us. That's why you see all the protection.

Some of today's airliners can fly direct from the U.S. continent to fairly deep into Asia – literally bypassing Japan. Will Japan become less and less important for you in the future as focus shifts to other parts of Asia where economic growth is higher?

Panagiotoulas: I don't think there's any negative impact whatsoever concerning over-flying. Rather, we're creating more choice and stimulating more demand in the region.

You've got the emerging markets: China, India, Vietnam; and there's a disproportionate amount of attention paid to these markets. But people seem to forget that we're talking about the second-largest economy in the world, here in Japan. If we're not successful in Japan, we're not successful in Asia.

Schwab: We are absolutely committed to Japan and it is very important to us and our customers. Direct flights to Asia allow us to open up capacity for our customers flying to Japan while providing more convenient service to customers going to Asia.

Duncan: The technology is improving and people want to fly nonstop, so we provide that service. Still, the Japan market is huge and people still want to come here. One result [of the over-flights] is you're going to see fewer connecting passengers going through the airports [in Japan.]

What are some of the peculiarities of operating in Japan?

Schwab: One point we make at the ACCJ is the competitiveness of Japan and its airports. It's a serious issue when the operating costs in Japan are much higher than at the airport hubs being constructed all around, outside Japan. We point

◀ SNAPSHOT ▶

The Japanese government is planning a significant liberalization of its highly regulated skies to ease access for international carriers to regional airports and Haneda Airport with its Asia Gateway Plan to cut ticket prices, revitalize local regions, benefit consumers and stimulate trade, it was announced in April.

Peter Harbison, executive chairman for the Centre for Asia Pacific Aviation, said: "If the regional markets of Japan, China and Korea were opened up there would be the potential for incremental growth of 300m people. It is a massive market waiting to be tapped."

In our industry, in 2005, almost 50% of U.S. airline capacity was in bankruptcy. That's not a healthy industry.



Passengers want service, efficiency, value, network and reliability, American Airlines Managing Director, Pacific Theo Panagiotoulis (right) tells moderator Geoff Botting (left), while subsidies, bureaucracy and price controls are anti-consumer.

this out to the Japanese airport operators and the government. Eventually, the old Japan hub [for Asia, Narita International Airport,] that we've loved so much over the past 20 years is going to move elsewhere in Asia if Japan is not careful about its own competitiveness.

Duncan: If you compare Incheon [South Korea], Japan is about three times as expensive. Before, the geography and technology were perfect for Narita.

The biggest problem with the Japanese airports is the split airports, so that three cities – Tokyo, Nagoya, Osaka – have two airports each. So if you're going from Los Angeles to Miyazaki, you fly into Narita, pick up your bags, take them to the bus to Haneda; at Haneda, you carry the bags again, check in and catch a flight to Miyazaki. But if you go to Incheon, you can make a smooth connection at one airport. You go Los Angeles-Incheon-Miyazaki.

And then, the Japanese are building airports in places where they're not needed: Kobe, Kita-Kyushu, Shizuoka. They're adding infrastructure in all the wrong places.

Panagiotoulis: The big issue is [the Japanese government restrictions on] pricing. You must let the marketplace determine pricing, instead of having government double-approval processes in place. It's anti-consumer to a large extent because we're not

able to get our products into the marketplace to benefit both the company and the consumer.

What's in the future for your mileage programs? Will they become more generous and user-friendly, or more stingy as part of your cost-cutting moves?

Schwab: Our Mileage Plus frequent flyer program remains an important way for us to serve and reward our most loyal customers. Airline miles are now a currency unto themselves. But because the flights are so full these days and the trend is not moderating, we're trying to provide our most frequent fliers more ways to use their miles and get award seats.

Panagiotoulis: The higher load factors are a challenge [to the mileage programs], so we've got to find solutions that work for our most valuable customers. One approach, for example, would be for a [mileage-points applied] ticket from Tokyo to New York, we would require X amount of miles. But we also give a second option. We tell our customers, "We'll let you have a seat on a nearly full flight if you're willing to use double your miles." We've got to start giving as many options as possible in an environment of very high load factors.

Duncan: Our program is also a great CRM

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[customer relationship management] tool. We can mine the data, say for a customer who flies to New York on business, and then work with a hotel to offer up a package when that customer goes to Guam or Bali. It helps us improve our relationship with customers.

Business travelers – how important are they to your operations in the Japan-Asia market?

Duncan: For a long-haul flight between Tokyo and the U.S. mainland, the airlines take on 30,000gal (114,000 L) of fuel. This involves such a massive cost that you really need to have business travelers on board, especially since leisure fares are so low.

Panagiotoulas: American has historically had a disproportionate focus on the premium traveler. It comes down to having the right schedule and network, especially for multinational corporations – especially in Japan. There are massive multinational corporations whose manufacturing facilities are spread all throughout the U.S. As for the corporate-business side, if you're not successful in premium travel, you can't be successful in the Transpacific.

Schwab: Most airline analysts estimate that approximately 10% of the customers generate around 40% of the total revenue.

We're all aware of the two widely divergent views between Boeing and Airbus over the future of air travel. Boeing envisions more mid-sized aircraft flying point to point. Airbus, with the development of the massive A380 double-decker airliner, favors passengers going to hubs, then transferring to smaller aircraft to their destination. What's your take on this?

Duncan: To me, it makes a lot more sense to take a customer directly to the destination. Our customers are telling us they want one flight.

Schwab: Our model is based on what our frequent business flyers say is most important to them. So having many nonstop flights per day is probably a better proposition than flying one lump of seats a day between city pairs.

Panagiotoulas: Our focus has always been on smaller wide-body aircraft, greater frequency consistent with corporate traveler needs.

Finally, what kind of innovations are you working on to make our flights more entertaining and relaxing?

Panagiotoulas: This year, the business class in our Boeing 777s will have an entertainment system that's literally removable. You can take it out from the front and move it around your seat. Effectively, it's a portable TV. You position it where you want it and it allows you to play video games or have theater on demand.

Schwab: The latest goody is iPod plugs, which the airlines are putting on their seats. It's all about flexibility. Letting customers watch the movie when they want, or listen to music when they want. Plugs are getting more common, like the universal computer plug.

Duncan: We've ordered the new Boeing 787s for 2009. They will open up all kinds of things. They've got the largest windows of any airplane and no window shades. You push a button, and a gas in the glass darkens. The 787 Dreamliner cabin has a lower pressure altitude. You won't be so dehydrated. After a long flight, you'll feel the difference.

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