EXCLUSIVE

A conversation with …

David Siegel, CEO, US Airways

INSIDE

Traditional carriers launch low-fare subsidiaries

How airlines weathered “the perfect storm”

Cathay Pacific Airways’ crisis management process
Riding the Storm Out

For nearly three years, various elements have converged to form a “perfect storm” for the airline industry. Addressing some of the causes and effects of the storm will result in changes that will reshape the industry.  

Like many spectacular tempests, the so-called “perfect storm” that hit the airline industry was preceded by deceptively beautiful weather. Although it may seem like an eternity has passed, the airline industry once found itself flying through the clear skies of relative prosperity as recently as three years ago. According to Steve Hendrickson, a partner with Sabre Airline Solutions Consulting, “things were calm and sunny” as recently as 2000. “The economy was riding high in ’99 and 2000,” he said. “You had your dot.com venture capitalists throwing lunch money, and people were saying, ‘Don’t worry about being profitable, just generate more eyeballs.’ Of course, we had Y2K grabbing a lot of activity. Even into 2000, they were still wrapping up Y2K projects. Then a lot of those projects were used as justifications for other modernization efforts: ‘As long as we’re going to clean up the code on the two-digit year, let’s also put a data warehouse behind this thing.’ So there were a lot of things helping the economy peak and even bubble, and we were enjoying the excesses of that period.”

**Signs of Trouble**

But in March 2001, a few clouds started to gather, said Ray Neidl, an airline industry analyst for Blaylock & Partners in New York City. Nothing too alarming — the booming North American economy began to cool. Following that, though, the storm clouds thickened as fuel prices rose and high-margin business travel slackened. Neidl said. Meanwhile, he added, airlines continued to add capacity, and labor costs in the United States jumped, sparked in part by an industry-leading contract United Airlines gave pilots to win support for its ill-fated merger attempt with US Airways.

And then came the lightning bolt — the events of Sept. 11, 2001, when four commercial aircraft in the United States were commandeered and crashed into the two World Trade Center towers in New York City, the Pentagon in Washington, D.C., and a field in Pennsylvania. Dramatic and damaging as it was, that lightning strike only marked the storm’s flashpoint. It was followed by conflicts in Afghanistan and Iraq and...
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The Early Factors

Even during the boom times, there were underlying problems in the industry, said long-time industry analyst Nawal Taneja. “Prior to ‘97-98, the industry was making gobs of money,” he said. “But some of the growth, even when times added raised the cost. The only difference is that before we were able to get away with charging higher fares to a certain segment of the traffic.”

Other pre-existing conditions also magnified the effects of the storm. “The proliferation of low-cost carriers is one of the aspects, and that goes back quite a bit,” Taneja said. “I would say that by the early ‘90s, they really got going and really started becoming more prominent. That’s my definition of the first event of the storm.”

Taneja — who has recently authored two books on the airline industry — also wrote: “Driving Airline Business Strategies Through Emerging Technology” and “Airline Survival Kit: Breaking Out of the Zero Profit Game” — said the availability of low-cost carriers on more routes has given travelers a viable alternative to the traditional carriers, and they were well-positioned to draw traffic during an economic slowdown. Indeed, some low-cost carriers have continued to earn profits despite the raging storm.

Another pre-existing factor also helped magnify the effects of the storm, Taneja said. “The development of the Internet (as a distribution channel) completely changed the industry,” he said. “It made fares transparent, that there is a lower fare available to the business traveler.”

The Internet also revealed the conditions required for a business traveler to take advantage of lower fares. They might have to travel to an alternate airport where a low-cost carrier is based, or make a connection as opposed to a non-stop. But, with the volumes of fare information available on the Internet, Taneja said travelers could now make “a choice based on knowledge they had gotten” rather than relying on an intermediary who had a vested interest in steering customers to a higher fare.

With the growth of the Internet as a distribution channel, practices travelers developed while shopping online for the family vacation soon spilled over to planning corporate travel. “People flocking to the Internet learned how to do their comparison shopping,” Hendrickson said. “I believe we’re seeing the consumer paradigm change. I used to accept the US$1,600 fare if I was booking two or three days in advance of my trip. Today, I find that unacceptable.”

Of all the elements of the storm, the development of online distribution packed the most powerful punch,


data from IATA shows that historically, passenger load factors have followed a consistent pattern that was disrupted by events such as Sept. 11, 2001, and the outbreak of SARS in early 2003.

The profitability of airlines during the last 10 years has swung dramatically, ranging from losses following the first Gulf war to healthy levels in the late ’90s and back to losses with the start of the “perfect storm.”

The constant piling on of adverse circumstances seemed to some in the industry to parallel the ancient story of the plagues that once afflicted Egypt. “I hope we don’t have a wave of locusts,” Northwest Airlines Chief Executive Officer Richard Anderson remarked to a reporter during the SARS outbreak. “We’ve had war, and we’ve had plague, I guess, and we seem to have sort of one event after another.”

Individually, the elements in the storm would have each had an impact. Working in combination, however, they drenched the industry, flooding it with financial setbacks during what many call the worst period in commercial aviation history.

The Storm’s Effects

The damage report, according to the International Air Transport Association, indeed paints a stark picture.

In 2001, seemingly every performance measure kept by IATA fell: kilometers flown, aircraft departures, hours flown, passengers carried, freight tons carried, passenger kilometers flown, available seat kilometers and passenger load factors. The picture didn’t improve much in 2002. The total number of passengers carried by IATA members fell another 2.1 percent in 2002, and, on top of that, they paid less to fly: yields shrank by 0.3 percent for the year. Kilometers flown, which had increased by at least 5 percent from 1998 to 2000, dropped 0.5 percent in 2001 and an additional 1.1 percent in 2002.

The financial impact, naturally, was almost incomprehensible. In 2001-02, according to IATA, the world’s airlines combined to lose US$24.7 billion — more than the gross domestic product of Nicaragua for the same period.

Nearly three years into the industry’s downturn, “I hope we don’t have a wave of the plagues that once afflicted Egypt,” Hendrickson said. “It was a whole bunch all that combined to keep an already seismic industry to parallel the ancient story of the plagues that once afflicted Egypt. “I hope we don’t have a wave of locusts,” Northwest Airlines Chief Executive Officer Richard Anderson remarked to a reporter during the SARS outbreak. “We’ve had war, and we’ve had plague, I guess, and we seem to have sort of one event after another.”

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The outbreak of the deadly severe acute respiratory syndrome in Asia — all of which combined to keep an already skittish traveling public at home. “It was just like a perfect storm,” Neidl said. “It was a whole bunch of different things that were coming into play at the same time … none of them good.”

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Hendrickson said. “You can measure the storm by the damage it’s caused, and the damage is showing up on the bottom line and the top line. It’s not just the bottom line. The revenue line has fallen apart.”

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Seeking Cover

The response by a thunderstruck industry to the deluge was swift and drastic. Thousands of employees were furloughed, hundreds of aircraft were parked and marginal routes were cut. Around the world, governments attempted to provide some shelter for airlines. In the United States, the government put together a package of US$5 billion in cash and US$10 billion in loan guarantees to compensate for the effects of 9/11. Both U.S. and European governments helped underwrite terrorism insurance for airlines. In the United States, the government put together a package of US$5 billion in 2002.

According to IATA, new security regulations cost airlines US$5 billion in 2002. "Technology, I believe, is not being utilized to the fullest to help them restructure," he said. "I think that it could not only be an enabler of some of these changes, but perhaps a driver. There is no question in my mind that technology has become much more of a tool that they can use."
Taneja said, because “the Internet simply changed travel distribution and passengers’ behavior.”

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The response by a thunderstruck industry to the deluge was swift and drastic. Thousands of employees were furloughed, hundreds of aircraft were parked and marginal routes were cut. Around the world, governments above the rising water, some could not escape the storm. The fallout included the failure of weaker airlines and bankruptcy court protection for others seeking to restructure their businesses.

Those who have survived have made needed changes, Taneja said. “The general direction is correct,” he said. “My only question would be the speed with which they are moving and the depth to which they are moving.

Airplanes are technology (as well as) information technology and technology such as mobile communications. “I think the most fundamental part of all of this is information — having access to information in almost real-time in a very pervasive manner,” he said. “There should be one unified view of this information available across the board.”

The cost of investing in technology, he said, will pay off for airlines. “In the long run, the cost is minute compared to the benefits it can provide, assuming you are willing to capitalize on that benefit. You do not just need a new system, but you need a new culture.”

By investing in technology and making necessary changes, airlines can position themselves to stand on solid ground when the sunny skies return, Taneja said.

A Changed Environment

While the worst may have passed, the storm lingers. According to IATA, overall passenger traffic for the first half of 2003 was 7.1 percent below 2002 levels. And capacity remained significantly down, led by the Asia/Pacific region (a decrease of 27.2 percent) and North America (12.5 percent). Yet, the end of the storm may be in sight.

“Now, I see a rainbow,” Neidl said. “I’m looking for an improved economy. I’m looking for cost cutting to really take effect later on this year or early next year. I’m looking maybe for even some continued reduced capacity by the major carriers. All those things combined, I’m looking for the industry to return to profitability maybe in the third quarter of next year.” But, even after it subsides, the severity and duration of the storm will have lasting effects.

“The industry has changed,” Neidl said. “The Internet makes it easier to shop. The low-cost carriers are really gaining significant market hold, and the big carriers are never going to be able to get the revenue premium they had before.” Some of the changes have had immediate impacts. Following the events of 9/11, increased security — and its cost of investing in technology — was one of the first and most visible to passengers.

According to IATA, the main traffic and capacity trends — revenue per kilometer, freight ton kilometers and available ton kilometers — dropped significantly following the events of Sept. 11, 2001, and again earlier this year after the outbreak of SARS. The cost of investing in technology and technology such as mobile communications.

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Who

Royal Brunei Airlines and Regional Express Airlines

What

Successfully implemented the Sabre® Traverse™ loyalty management system to automate their frequent flyer programs, Royal Skies and Regional Express Flyer, respectively. The airlines access the Traverse system via the Sabre® eMergo® Web-enabled and dedicated network solutions, an applications service provider model that eliminates the need for costly and complicated in-house data center infrastructure and support.

Why

Royal Brunei — “We want to reward our Royal Skies members with a full range of features and benefits through new partnerships and multi-faceted promotions and awards. The Traverse system has enabled us to do all this and more, and we are extremely pleased with the positive feedback from our customers from the date Royal Skies was launched,” said Hj. Dul Hj. Mosh Daud, director of marketing at Royal Brunei.

Regional Express — “With the addition of the Traverse system, we will be able to provide our Regional Express Flyer members with greater customer service than we could previously,” said Hans Van Pelt, chief information officer at Regional Express, a domestic regional carrier in Australia with 1,500 flights per week. “The ASP interface also enables us to eliminate the burden of maintaining a costly infrastructure to support our loyalty program; now we have an effective customer self-managed program completely online.”

Heightened airport security has put another burden on airlines as they have struggled to cope during the perfect storm. According to IATA, new security regulations cost airlines US$5 billion in 2002.
accompanying costs — have directly impacted airlines.

“The extra security that is needed at airports now has done two things,” Taneja said. “One, it has raised costs. The other one is simply having to show up at the airport a lot earlier to make a flight. Short-haul travel is going to be (particularly) impacted. If you are only traveling from Cleveland to Chicago, and you have to show up an hour and a half early on each end, that’s going to add a lot more time.”

But there are other long-lasting results as well.

According to Hendrickson, the industry “might be looking at climate change here.”

“Take fare transparency,” he said. “Initially the airline industry thought it was a great idea; bypass the global distribution system, give customers the ability to use online bookings, avoid commissions, lower distribution costs. But at the same time, they introduced the start of a revolution, which brought comparison shopping and completely emphasized price. That genie has come out of the bottle and will not go back in. There’s no way you’re going to reverse that trend, so that’s here to stay.”

Hendrickson also noted that, historically, there was a strong relationship between GDP and industry revenues. During the past few years, however, that relationship seems to have broken.

“That strikes me as something that may not be cyclical,” Hendrickson said. “That might be a fundamental change in the way this economy looks at the change. That’s what I think is most alarming. We can always fight over share, but if the economy is switching its view of travel as a facilitator of something else, then we’ve got some real problems.”

Taneja agreed the look of the industry has been irreversibly changed. The severity of the storm revealed underlying conditions in the industry that could no longer be ignored, he said.

“I don’t think we’re ever going back to the way we were,” he said. “I’m not saying that airlines will continue to lose money at the rate they are forever and ever. They will turn around. But in order for them to turn around, they are going to have to change their business models significantly.

“If you are a traditional legacy carrier, the change will be more drastic and dramatic,” he said. “But even the new paradigm airlines are going to have to change.”

Traditional carriers will “have to reduce their costs and not just labor costs,” he said, but also will have “to pick very carefully the customers that they want to serve.”

“If you decide you are going after a kind of customer, that will determine what your scope is going to be and the type of network and the type of fleet and the type of customer service and onboard products and so on,” he said.

For low-cost carriers, increasing competition among themselves — and from revamped traditional carriers — will force them to change as well, he said.

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