Up in the Air: Can an Industry Compete on Costs Without Destroying its Workforce?

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Context for Study

• Structural shift in the U.S. industry since 2000
  – Successful entry and growth of LCCs
  – Over $30 billion losses and more than 10 bankruptcies—4 in large airlines
  – 100,000 job losses; $15 billion wage/benefit losses
  – Plummeting employee morale
  – Mounting service quality problems

• Other parts of the world have seen even more rapid rise of LCCs in recent years
# Growth of low cost sector around the world from 2001-2003

<table>
<thead>
<tr>
<th>Region</th>
<th>Flights/week (August 2001)</th>
<th>Flights/week (August 2003)</th>
<th>Percent change</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>23,800</td>
<td>30,100</td>
<td>27%</td>
</tr>
<tr>
<td>Europe</td>
<td>4,150</td>
<td>10,060</td>
<td>140%</td>
</tr>
<tr>
<td>Asia</td>
<td>555</td>
<td>990</td>
<td>78%</td>
</tr>
<tr>
<td>Australia/New Zealand</td>
<td>136</td>
<td>1,340</td>
<td>885%</td>
</tr>
<tr>
<td>Total</td>
<td>28,641</td>
<td>42,490</td>
<td>48%</td>
</tr>
</tbody>
</table>

Source: Drew Magill, Low Cost Carrier Market, Boeing, April 2004
This Study

• Within the MIT Global Airline Industry Program, Gittell, Kochan, McKersie and von Nordenflycht responsible for labor/HR component

• Put together a team of researchers from around the world through Labor and Employment Relations Association’s Airline Industry Council

• Question: Can we build a sustainable industry that balances the interests of investors, employees, customers and the communities/nations they serve?

• Method: Draw on case studies and other research of team members from around the world and our research in the U.S.
Analytic Framework

• **Competitive Position**
  – Legacy vs. LCC

• **Employment Relations Strategy**
  – Control vs. Commitment
  – Avoid, Accommodate or Partner with Unions
Legacies vs. LCCs

• *Legacies* are airlines that were founded prior to deregulation and were designed to compete in a regulated environment
  – developed hubs to serve small markets more efficiently and to defend their turf
  – tend to have older employees and older aircraft

• *LCCs* are airlines that were founded after deregulation (or just before) and were designed to compete in a deregulated environment
  – rely less on hubs and serving small markets
  – tend to have younger employees and younger aircraft

• Both sectors increasingly compete on costs due to price-sensitive consumers
2004 snapshot: LCC costs were 63-75% of legacy costs – U.S. costs lower than Europe, higher than Asia

<table>
<thead>
<tr>
<th>Region</th>
<th>Legacy Airlines</th>
<th>Low Cost Airlines</th>
<th>Low Cost / Legacy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>.138</td>
<td>.103</td>
<td>75%</td>
</tr>
<tr>
<td>U.S.</td>
<td>.111</td>
<td>.080</td>
<td>72%</td>
</tr>
<tr>
<td>Asia/Pacific</td>
<td>.102</td>
<td>.064</td>
<td>63%</td>
</tr>
</tbody>
</table>

Source: ICAO data
More detailed U.S. data suggest

- Legacies have reduced the labor cost gap dramatically
  - But other costs are growing for them faster than for the LCCs (fuel, transport-related costs)

- Productivity has grown dramatically for both sectors
  - But low cost airlines are retaining their advantage on most measures

- Service quality is an increasing challenge for both sectors
On-time performance way down after rising amidst low traffic post 9/11

Source: U.S. Federal Aviation Administration, Air Travel Consumer Report
Similar pattern with baggage handling

![Graph showing mishandled bags per 1,000 passengers enplaned from 2000 to 2006 for U.S. Legacy Mishandled Bags and U.S. Lowcost Mishandled Bags. The graph shows a similar pattern for both categories with a peak in 2005 and 2006.](source_image)

Source: U.S. Federal Aviation Administration, Air Travel Consumer Report
Legacy complaints way down since debacle of 2000, though rising again in 2007

----- Anticipated 2007 increases based on recent data

Source: U.S. Federal Aviation Administration, Air Travel Consumer Report
Cancellations dropped after 2000, but are beginning to rise again

----- Anticipated 2007 increases based on recent data

Source: U.S. Federal Aviation Administration, Air Travel Consumer Report
Employee morale has declined since 2000

Positive views of employee morale

Source: The Wilson Center for Public Research, Inc. – based on 165,203 interviews conducted with pilots or flight attendants from 1/1/2001 to 9/12/07. The specific question read as follows: “How would you describe, in your own words, the pilot [flight attendant] group’s morale?”
Along with support for management

Positive views of how management is running the airline

Source: The Wilson Center for Public Research, Inc. – based on 165,203 interviews conducted with pilots or flight attendants from 1/1/2001 to 9/12/07. The specific question reads as follows: How would you describe, in your own view, how [company name’s] management is running the company.”
Perhaps related to downsizing (and perceived focus on labor costs rather than broader costs)

Source: U.S. Department of Transportation, Form 41
Analytic Framework

• Competitive Position
  – LCC vs. Legacy

• Employment Relations Strategy
  – Control vs. Commitment
  – Avoid, Accommodate or Partner with Unions
Control vs. commitment

• *Control* is the traditional approach to managing people
  – specifying what needs to be done and requesting that employees *comply* with those needs
  – sometimes called compliance approach

• *Commitment* is an alternative approach to managing people
  – engaging employees to *understand the interests* of the organization and its customers and *act accordingly*
Avoid, accommodate or partner with unions

- *Avoid* means to actively discourage employees from unionization
- *Accommodate* means to ‘put up with’ unions and negotiate with them as required, maintaining an arms length relationship
- *Partner* means to develop a closer relationship with unions, sharing more information and more often than required, seeking mutual gains solutions
Employment Relations Strategy

Note: Competitive position indicated by color – legacy (blue) and LCC (pink)
Observations regarding control vs. commitment

- *Control* more common than *commitment* in this industry for both LCCs and legacies
- Some airlines are moving toward *commitment* approach
  - Continental successfully achieved change in the mid-1990s
  - American, Air Tran and EasyJet trying more recently
- *Commitment* approach can work with different union strategies
  - avoid unions (JetBlue, Delta)
  - accommodate unions (Continental, VirginBlue)
  - partner with unions (Southwest)
Observations regarding avoid, accommodate or partner with unions

• *Accommodate* has been most common strategy toward unions in this industry, for legacies and LCCs
• Some have moved from *accommodate* to *avoid*
  – Continental/Eastern in past
  – Qantas moving in this direction with JetStar?
• Some have tried moving toward *partnership*
  – American, British Air, EasyJet, Aer Lingus
  – varying degrees of success
  – airlines have often sought union support for lowering costs
    but it’s a difficult path to negotiate
  – requires a *desire to partner* by employees and their unions
• Two of the most successful LCCs are following opposite employment relations strategies
  – Ryanair – control/avoid unions
  – Southwest – commitment/partner with unions
• Our interviews revealed that these two LCCs are serving as competing role models for start-ups
• Sometimes internal battles are evident
• Many are opting for hybrid approaches
  – JetBlue – commitment/avoid unions
  – VirginBlue – commitment/accommodate unions
Under pressure, Southwest maintains high commitment/partnership approach

- Now largest carrier in U.S. domestic market
- Nearly highest *labor* unit costs – but nearly lowest *total* unit costs
- Baggage handling has lagged – but top performer on complaints and delays
- Wall Street analysts questioned SWA’s high wages – response?
- “It’s true, our employees are well-paid. *They’ve produced the most efficient, most profitable airline with the best customer service and they deserve to share the wealth* .. Our people know what the airline industry environment is like. I am confident they will do what it takes to keep SWA on top. I would consider it a failure if we have to go to our employees and tell them to take a pay cut.” (CEO Gary Kelly, *Wall Street Journal*, 12/19/05)
Conclusions

• Multiple approaches to the employment relationship—within and across legacy and LCC segments
  – Several of these approaches can work well for investors
  – We predict that the best outcomes for employees (and perhaps for customers too) will follow from a high commitment, partnership approach
  – More challenging to achieve than other approaches

• Answer to the title question: Can an Industry Compete on Costs Without Destroying its Workforce?
  – Yes, but achieving a better balance in outcomes will take continued changes

• Alternative scenarios
  – Option 1: Building toward the “perfect storm”
  – Option 2: Learning and change: Airline by airline; union by union
  – Option 3: Airlines, government and unions join to build a sustainable industry