The American Way

American Airlines has taken the road less traveled as it seeks to create long-term competitive advantage without resorting to Chapter 11.

By Perry Flint
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Six weeks ago, American Airlines parent AMR Corp. surprised Wall Street with a handsome second-quarter net profit of $291 million. To put this achievement into its proper perspective, the last time AMR earned as much, fuel was selling for around 80 cents a gallon, yields were rising toward 14 cents per passenger mile, Bill Clinton was completing his second term in the White House and 911 was what you dialed in an emergency.

It is a tribute to how far American has come since the bottom dropped out in 2001 that it could generate its strongest quarterly performance in six years during a period in which it paid an average of $2.09 per gallon of fuel and achieved a yield of just 12.81 cents per RPM. "It's the best we've seen in a very, very long time," Chairman and CEO Gerard Arpey agreed to ATW at the carrier's headquarters here. Certainly, it is the best Arpey has seen since replacing Don Carty at the top during the carrier's near brush with bankruptcy in the spring of 2003. American dodged Chapter 11 by the skin of its teeth after its employees accepted $1.8 billion in annual wage and benefit givebacks and the elimination of 9,300 jobs while the airline squeezed vendors, lessors, lenders and suppliers for a further $200 million per year.

Since then, Arpey has taken AA on a vastly different course than the one followed by most of his legacy airline counterparts. As he often points out, American is the only major US network carrier that has not sought to restructure and slash its labor costs via the bankruptcy court over the past quarter-century. In contrast to nearly all of its network rivals, it has preserved and continues to fund its employees' defined-benefit pension programs, and the wage cuts it imposed in 2003, while hefty, are not as severe as those absorbed by employees at United, Delta, Northwest and US Airways, or at Continental during its two pre-9/11 reorganizations and where employees recently agreed to $500 million in givebacks.

Moreover, like Gordon Bethune at Continental a decade earlier, Arpey is genuinely trying to create a new company culture uniting labor and management in a shared vision of the future. Bethune had "Fly to Win." Arpey has the "Turnaround Plan," which rests on four pillars: Lower Costs To Compete; Pull Together, Win Together; Fly Smart Give Customers What They Value, and Build a Financial Foundation. He meets regularly with the airline's organized labor groups and has opened the corporation's books to them. "We have made a conscious decision to make organized labor a partner," he stresses. "If you ever allow yourself or your management to identify labor as the problem, you are not only wrong, you also cause everyone else to wait for the solution." Instead, AA has become an enthusiastic proponent of Continuous Improvement.

Labor Arbitrage

Significantly, Arpey has declined to follow the example of his peers by closing AA's hangars and outsourcing its maintenance needs to third parties, a practice he derisively refers to as "a labor arbitrage." Facilities at Tulsa, Kansas City and Alliance Airport continue to hum. AA is introducing CI into the MRO activity -- Tulsa can now perform an MD-80 heavy C check in 12 days, down from 24 -- and is developing its third-party MRO capability. Such work added $50 million in revenues in 2005 and contributed to a 21% jump in the "other revenue" category in the second quarter of 2006.

"What we've been focused on is creating long-term competitive advantage through process change and not short-term advantage which can easily be reversed," Arpey tells this magazine. He notes that employee ideas are behind many of the gains, including a number of fuel-saving initiatives (consumption fell 1.6% in the second quarter on a 0.9% decrease in ASMs) and the decision to remove the rear galleys on the airline's MD-80s and add a couple of rows of seats, a step that simultaneously saves weight and MRO costs while creating a new revenue opportunity.

Working with the Allied Pilots Assn., American has changed its crew scheduling practices to keep pilots with aircraft throughout the day so that a flight delay in New York doesn't result in a second late departure -- or cancellation -- somewhere else, and to assign certain aircraft to specific hubs rather than flowing them throughout the system. It is now in the third round of its "hub simplification" process that began with the depeaking of its major hubs at Chicago O'Hare, Dallas/Fort Worth and Miami starting in 2002 *(ATW, 11/02, p. 22)*. In the latest phase, it aims to turn aircraft faster by staggering departure patterns across a pair of gates. Aircraft productivity (miles per day) is up 9% since 2003, while ASMs per employee have climbed nearly 20%.

Yet while he is proud of the carrier's progress, Arpey also recognizes that bankruptcy has given his rivals a significant cost advantage. Company data show that on a stage-length-adjusted basis, AA had the highest unit labor costs of any US Major (see table, p. 48). According to JP Morgan, a 12-year AA 737 captain earned $161 per hr. versus $149 for a Delta captain, $144 for Continental, $137 for Northwest and $131 for United. Only Southwest paid more -- $186 -- and its pilots are generally considered to be the most productive in the industry. American has tried to mitigate this by searching elsewhere for savings and has cut $3.5 million in non-labor costs since 2002; it claims to have the best nonlabor CASM performance in the industry excluding Southwest.

It also has introduced a slew of new revenue-producing products, such as Confirmed Flight Change providing guaranteed seats on same-day flights for $25, purchased upgrades, buy-on-board snacks and the introduction of credit card readers to permit passengers to buy food and alcoholic beverages with plastic. It charges fees for tickets purchased through its reservation centers rather than online and for curbside baggage check-in.

These and other initiatives paid off in the second quarter when AA led the legacy side of the industry in operating and net margins, and Arpey can't resist a dig at his reorganized competitors: "I can't help but be pleased that American managed to keep pace with those who used bankruptcy to lower their costs." But he also quickly acknowledges that "One good quarter does not wipe out the billions of dollars lost" since the end of 2000.

In fact, it's just a drop in the bucket compared to the $8.1 billion AMR has shed in the past five years, and funding those losses caused the debt burden to jump from $13.2 billion in 2000 to nearly $20 billion by the end of the first quarter of 2006. Nevertheless, the trend line has been moving in the right direction, with losses excluding special items narrowing from $2 billion in 2002 to $681 million last year. For full-year 2006, the consensus view on Wall Street is for earnings of around $500 million, rising to close to $1 billion in 2007.

To get there, however, American will have to dig for new savings to offset an estimated $1 billion-plus in additional fuel expense and $600 million in nonfuel-related inflationary costs including paying for sparking terminal facilities at DFW and New York JFK that opened last year. It already has announced plans to cut $700 million in spending this year, including parking 27 MD-80s, flattening its summer peak and reaping savings from renegotiated contracts with major global distribution systems. It aims to boost revenue $300 million as well, but officials here admit that this is just running faster to stay in the same place.

Last December, Arpey unveiled the Performance Leadership Initiative, a collaborative effort aimed at measuring AA's efficiency and productivity against best-in-class companies inside and outside the industry. One outcome was a decision to reduce management and supervisory staff by 5%. In total, the airline's workforce currently numbers 83,160, down from 101,199 at the end of 2000. An avenue that does not appear to be open at the moment is a new round of labor cost reductions. Labor contracts do not become amenable until 2008 and unions remain extremely sensitive to the cuts they took in 2003.

Number One

Of course, AA does enjoy some key advantages. It is, after all, the world's largest airline in terms of passengers (98 million last year), RPKs (222.6 billion) and fleet (691 aircraft, although some are parked). Its 2005 annual revenues of $20.71 billion placed it first among all US carriers and third on the planet behind Air France-KLM Group and Lufthansa Group. In combination with its Regional affiliate American Eagle, which operates 259 aircraft, it serves 250 destinations in 40 countries with 3,900 flights a day. Its route network, while more exposed than others to the brutally competitive US domestic market, nevertheless has a strong international component and such operations contributed $7.47 billion in revenue last year, or 36% of the total, led by Latin America (17% of revenues), transatlantic (15%) and transpacific (5.9%).

Although it is a small player in the Asia/Pacific compared to United and Northwest, its long campaign to boost its presence there paid off with the April launch of daily 777-200ER service to Shanghai from Chicago O'Hare. Last year it inaugurated Chicago-Delhi flights and also launched service between Osaka and Dallas/Fort Worth, its fifth international route to Japan following cancellation of San Jose-Tokyo Narita. It has applied for a new China route, Dallas-Beijing.

Senior VP-Planning Henry Joyner says both the Shanghai and Delhi services are off to strong starts. The latter is benefiting from the substantial Indian expatriate community in the Chicago region. One challenge, he admits, is making them aware of the nonstop opportunity, since many are accustomed to traveling one-stop via Europe.

Portfolio Management

Although international services are growing steadily -- ASMs rose 8.6% last year versus a 2.3% decline in domestic seat capacity -- Joyner draws a distinction between AA and some of its rivals that have embarked on aggressive expansion to Europe and Latin America. Using the analogy of financial investing, he says American approaches network planning with a long-term focus and a "disciplined portfolio investment strategy." Others, he suggests, pursue "tactical investing . . . chasing after 'hot' corporations." He leaves little doubt which method he believes is superior.

Discussing the carrier's strategy in Europe, he says the "most efficient" way to grow is via the hubs of its oneworld partners such as British Airways, Iberia and Finnair. There will be some "point-to-points," such as seasonal service from Boston to Shannon and Manchester, but by and large the main opportunities come from codesharing beyond London, Madrid and Helsinki, for example. Executive VP-Marketing Dan Garton says revenues from oneworld codeshares are up

20% year-over-year and represent AA's fastest-growing stream of passenger revenues. He says he "can't wait" until Japan Airlines becomes a member.

Not withstanding that current expansion is focused on international markets, Joyner believes "growth opportunities will continue in the US." Although the air travel market may be mature in the sense that it grows at the rate of GDP, "that's not so shabby -- 3% growth per year [is] a lot of demand."

Here again, AA is well-positioned. It is the largest US domestic airline, with a 20% share of RPKs (it trails Southwest in enplanements). It is the leading carrier in 17 of its top 20 markets with a better than 50% passenger share in 16 of them, according to JP Morgan. At its largest hub, DFW, it offers 505 daily departures to 109 destinations, with Eagle adding a further 285 departures to 75 destinations. In a recent report, Credit Suisse put AA's scheduled seat market share at DFW at 84%. Furthermore, it appears that the long-festering sore of Dallas Love Field may at last be healed under an agreement among AA, Southwest and the cities of Dallas and Fort Worth.

Thanks to government slot controls, it also has been able to remain highly competitive at O'Hare, which otherwise likely would have fallen to United years ago. Instead it maintains a 38% seat share, also according to Credit Suisse, with 240 daily departures to 73 destinations, while Eagle offers 266 departures to 69 destinations. At Miami, which is probably AA's largest international hub owing to service to its extensive Latin America/Caribbean network, it enjoys a 65.8% share with 202 departures to 80 destinations while Eagle adds 47 to 21 destinations.

After struggling to make St. Louis work as a major connecting hub, the airline reduced its presence there in 2004, with Eagle assuming the leading role. Garton says STL is now "a fairly successful 'hubette' targeted to local customers." He notes that a "hub that relies on flow or connecting traffic is going to have a hard time making money."

Here too AA is looking good. Using DOT data, Credit Suisse figured that in 2005, 34.6% of its traffic was local, ahead of Delta (22%), US Airways (29%) and Northwest (29.6%) and a bit behind United (35.1%) and Continental (36.6%).

As Garton notes, American does more nonhub flying than most of its rivals, with "huge amounts" of transcon traffic (a fact that bothers some on Wall Street given the greater exposure to LCCs). In fact, its biggest city-pair market in 2005 was JFK-Los Angeles, where it is No. 1, carrying an average of 1,000 passenger per day at an average yield on the 2,467-mi. flight of 12.1 cents (JP Morgan). It is also the top carrier from JFK to San Francisco as well as between Boston and LAX, according to the same source.

While acknowledging that transcon yields took a beating when JetBlue and America West expanded in the markets in 2004 (both since have pulled back), Garton says United's PS product offering three-class service in specially configured 757s between JFK and the West Coast has not had an impact. He points out that AA operates 767s on the route with three classes of service, and he is largely dismissive of the UA effort: "United right now is all about branding. We are not about branding."

Simplify

So what is American about these days? In a word, simplification. "We believe you should be simplifying and lowering costs," Garton says. "Instead of further refining strategies, [we're asking] how do you simplify the business?" adds Joyner.

Arpey cites the recent decision to return 19 ex-TWA 757s when leases expire in 2007-08 as an example of how the airline thinks today. In the past, it might have been tempted to exploit the

performance capabilities of the aircraft in hopes of gaining incremental revenue. Today, the focus is on driving down costs and these aircraft have different engines, different interior configurations and are on a different maintenance program than the rest of the 757 fleet. AA expects to save $50 million in annual lease costs and officials are not concerned about the loss of seats. "This industry's problem is not a lack of capacity and aircraft," Arpey dryly observes.

American also has simplified its fare structure, a process that began in November 2004 in Miami in response to low-fare incursions at Fort Lauderdale, with a systemwide rollout in January 2005. It lowered its highest coach and first class fares, reduced the number of fare categories and eliminated the Saturday night stay for most fares. The new structure "made us far more competitive" against LCCs, VP-Revenue Management Scott Nason says.

And despite the fact that it has been a leader in terms of imposing fare increases this year, AA achieved a record load factor of 82.6% in the second quarter with yield up 7.6%, the fifth consecutive quarter of year-over-year yield improvement. It also continues to attract a disproportionate share of business traffic. Nason declines to provide specifics but says the ratio of business to leisure is "not too far from 50/50."

Although simplification is having its desired effect, officials here are not ready to consider any broad expansion plans, particularly in light of today's soaring fuel prices and AA's huge debt burden. "Balance sheet repair is clearly a priority for us," VP-Corporate Development and Treasurer Beverly Goulet confirms. Full-year capacity will be down about 1%, reflecting a 3% drop in domestic ASMs partly offset by a 4% rise in international ASMs.

AA has yet to give capacity guidance for 2007, but Arpey makes it clear that growth is not high on the agenda. "I think we're going to continue to be pretty prudent when it comes to looking at capacity," he said during AMR's second-quarter webcast.

The company received some good news from Washington as this was being written when Congress approved pension reform legislation that will give it some breathing room to address its $2.3 billion pension funding deficit and may help to placate its labor unions, who sharply protested July pay hikes for Arpey and several senior executives. It is difficult to know whether the outcry was largely ritualistic or reflects genuine unhappiness with senior management and the direction of the airline. Were it to be the latter, it would be unfortunate, given how far American has come and how hard Arpey has worked to preserve those things that appear to matter most to employees.

Even today, as executives watch Delta and Northwest ratchet down pay scales and peel away debt in bankruptcy, Arpey declines to make organized labor a target. He tells ATW that the Performance Leadership Initiative has uncovered "lots of opportunities" to make AA more competitive, but he says it is up to the unions to decide whether to "close the gaps." Nor will he offer the carrot of growth to try to win more efficiency: "I do think we need to stay focused on the fact that the paycheck and benefits package [at AA] is a pretty good carrot." Still, he adds, "if we can get competitive and sufficiently profitable and keep it there, we will grow."