EDITORIAL

Outrunning the bear

By Perry Flint

There's an old joke about competition in the airline industry and it goes something like this: Two airline CEOs are on a camping trip when they see—and are seen by—a large, hungry grizzly bear. The first CEO immediately takes off his hiking boots and starts lacing up a pair of running shoes. The second says, "Are you crazy? You can't outrun a bear!" To which the first replies, "I don't have to outrun the bear. I just have to outrun you."

Sadly, there's an element of truth to this joke, because for the last decade or so that's the way competition among the legacy airlines has been managed: Don't confront the bear, meaning the rising tide of low-cost carriers. Instead, put your energy into staying just ahead of the other guy, who more or less is the same as you.

It's a strategy that worked in the second half of the last decade when the dot.com and telecom bubbles floated all boats, even the leaky ones, although the bear grew bigger and bolder on a diet of California, the Mid-Atlantic and Florida. But it doesn't work any more. This industry just came out of one the strongest traffic summers in recent memory, with record sustained load factors and traffic back to 2000 levels. There was no terrorism, no new war, no dread disease. Yet virtually every fare increase by a network airline failed despite a desperate need to recoup some of the money being burned up on $40-a-barrel oil.

The system isn't broken; the system is history. Anyone who doubts it should get hold of US Airways' latest bankruptcy filing, in which the carrier observes that it achieved nearly all of the stated goals of its first reorganization while admitting that it failed to return to profit anyway. Nobody moved the goalposts—the airline simply was playing in the wrong stadium. US Airways admits its mistake was to focus on how to compete profitably against its larger network rivals rather than recognizing that the real threat lay in the growth of low-cost carriers "that have had a profound structural impact on the airline industry." Sure the price of fuel was a factor, but the company acknowledges that all it did was accelerate the "day of reckoning."

According to the Air Transport Assn., more than 70% of US passengers fly in markets served by LCCs, which collectively account for 26% of domestic capacity. US Airways believes that LCCs have crossed the "tipping point" and achieved pricing power in the general market. That day also may be coming to Europe, by the way: Credit Suisse First Boston recently calculated that LCCs have a 20% share of the market, which will rise to 33% by 2010.

In response to this challenge, US Airways aims for nothing less than cutting its unit costs by nearly 30% in order to operate at the same level of efficiency as JetBlue and America West, which it identifies by name. No other network airline has staked out such an ambitious goal, either here or in Europe. We don't think it can be done, but we give credit to the carrier's new management for realizing that gaining a half-penny lead over a United Airlines or American Airlines does not have a whole lot of relevance in the markets that matter. Unfortunately, it's clear that the rest of the industry, while making strides toward narrowing the gap with the LCCs, still plans to take its cue from United, which may or not recognize that it is playing the wrong game.

There are those who believe that all of the industry's problems will be solved if one or two network airlines fail. Certainly, in the short term, a shortage of capacity should force fares up. But much of the grounded lift is likely to be owned by institutions that have no interest in keeping their aircraft parked. The equity markets may or may not be willing to fund low-cost startups; however, we do not doubt that lessors will be very creative in arranging terms that make it possible for lots of bear cubs to get off the ground. And the airline that believes that outrunning its network rivals is a satisfactory solution is only playing a joke on itself.