VII. Conflict and Cooperation in Employment Relations as the Airline Industry Restructures: International Perspectives, Comparisons, and Futures

Blending Old and New: How Low-Cost and Legacy Carriers Are Reshaping the Airline Industry

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For much of the past decade the airline industry worldwide has been in the throes of a restructuring process dominated to date by the growth in market share of new lower-cost carriers and by wage, benefit, and working conditions concessions by employees in the large legacy carriers. In the United States low-cost airlines now account for approximately 26 percent of air traffic, up from less than 10 percent only a decade ago. Low-cost carriers also continue to gain market share in Europe, increasing from 2 percent to 7 percent between 1998 and 2001 and continuing to expand since then. Two new low-cost carriers now account for over 40 percent of the market in Australia. A central question for our global airline industry project, therefore, is how the pressures of the new low-cost entrants and the responses of the legacy carriers will interact and combine to shape the future of employment relations in this industry.

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This paper begins to explore these issues by drawing primarily on data from the United States and selected examples of developments in other countries. It is a preliminary analysis that will be revised and adapted as we gather more evidence from the case studies from around the world that are being carried out for the larger project in which this paper is embedded.

Theoretical Expectations

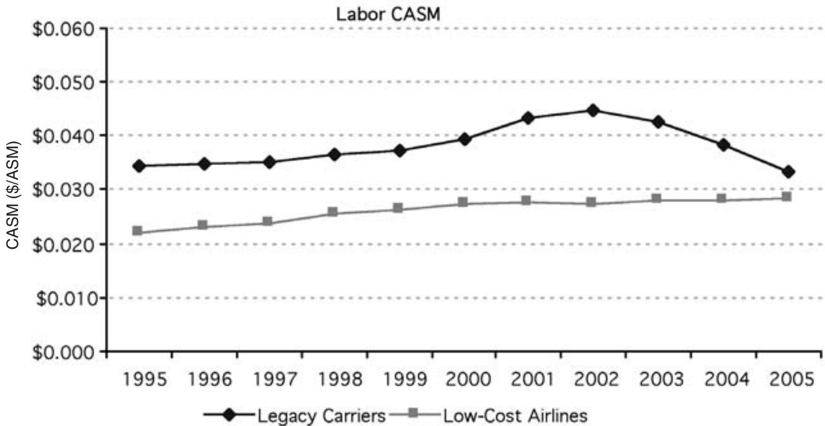
The first theoretical point to make is the obvious one: the entry and rapid growth of lower-cost competitors was and continues to be the major driver forcing legacy carriers to attempt to lower their labor and other costs through wage, benefit, and work rule concessions; layoffs; consolidations/mergers; and a variety of other strategies. These reductions come at great cost to the incumbent workforce, increase labor management tensions, and raise questions about whether cost reductions are both necessary and sufficient or necessary but not sufficient strategies for regaining and sustaining profitability. To the extent these legacy carriers are successful in lowering their costs, firms from the two sectors will find themselves competing in an increasingly crowded competitive space, thereby setting up a number of highly contested battles for market share. These developments suggest firms will need to continue to adapt both their business and the employment strategies to succeed in this contested space.

As traditionally low-cost firms age and their costs inch up closer to legacy carriers, strategy theorists would predict these firms need to move upscale in services provided (adding more “frills”) or risk a decline in profitability (Binnggeli and Pompeo 2005; Alamdari and Fagan 2005). Human resource and labor relations theory would predict that as labor cost differences decline, those firms with more positive human resource and labor relations practices will perform better than those with lower levels of worker coordination, morale, and trust and higher levels of labor-management conflict (CIPD 2006). Our U.S. research team advanced this proposition and found considerable support for it in the U.S. airline industry, prompting the specific prediction that sustained recovery at firm and industry levels will require improvements in human resource and labor relations practices and outcomes (Gittell, vonNordenflycht, and Kochan 2003; Kochan et al. 2005). How then are these predictions bearing out? We take a preliminary look using data from the United States and then compare the U.S. experiences with examples from other parts of the world.

Developments in the United States

The convergence toward the middle ground is clearly apparent in the United States. Figure 1 shows this vividly by tracking trends in labor costs per available seat mile (Labor CASM) from 1995 through 2005; the seven

FIGURE 1
Labor Costs at Legacy and Low Cost Carriers in the U.S., 1995–2005



large legacy carriers are compared to the six largest low-cost carriers. The difference in labor costs between the two groups remained fairly constant from 1995 to 2000 and then expanded considerably from 2000 to 2002. The layoff of over 100,000 employees (25 percent of the industry's workforce), concessions negotiated at the legacy carriers since 2002 either in bankruptcy or under the prospect of bankruptcy, and small but steady increases in costs at the low-cost carriers produced a reduction in the labor cost differential. Overall, the labor cost differential declined from 36 percent in 1995 to 15 percent in 2005. With the concessions at Northwest Airlines that took effect in 2006, this differential likely declined by a few additional percentage points in the past year. These data suggest that labor cost differences are no longer as significant a source of competitive advantage or disadvantage as they were in the past decade.

Figures 2 and 3 show a significant reduction in the total cost gap, declining from approximately 9.4 cents per available seat mile in 2001 to just under 8 cents in 2005 (excluding fuel costs and charges for purchased services from other airlines). It is also clear, however, that most of this reduction came from the decline in labor costs at the legacy carriers. Figure 3 shows that nonlabor costs have not declined nearly as much as labor costs. In fact, as much as three fourths of the 40 percent reduction in total unit costs may have come from labor cost reductions.

All the major legacy carriers have negotiated major wage and benefit concessions from their employees and unions. Four—US Airways, United, Delta,

FIGURE 2

Total Unit Costs, Legacy and Low Cost Carriers in the U.S., 2000–2005

Unit Costs (excl. "Transport & Fuel")

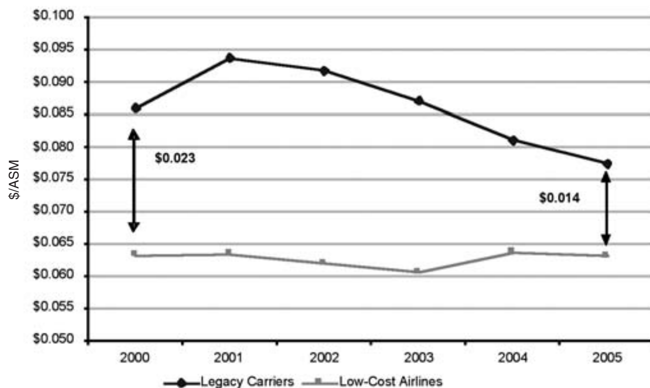
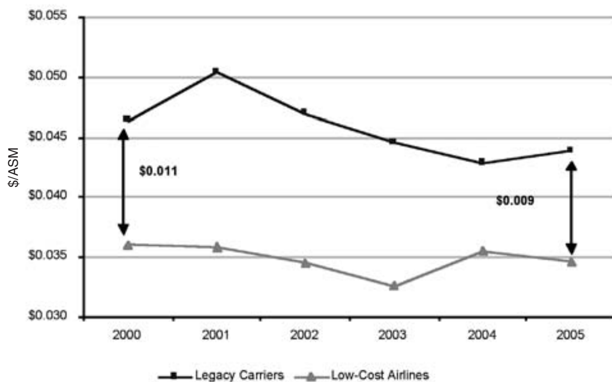


FIGURE 3

Non-Labor Unit Costs (excl. Transport & Fuel)

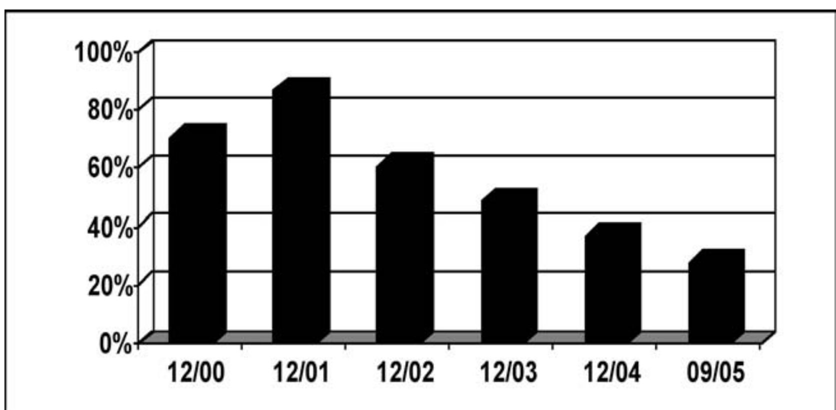


and Northwest—negotiated these cuts during bankruptcy proceedings, while American and Continental negotiated somewhat smaller reductions without resort to bankruptcy. Figures 4 and 5 provide a vivid picture of the impacts of these developments on trust and morale in the U.S. airline industry. These data come from surveys done of pilot and flight attendant groups across a sample of thirty airlines between the years 2000 and 2005. They document the precipitous decline in morale and trust in management expressed by workers in these firms over this time period. Trust in management declined from its peak of nearly 80 percent shortly after 9/11 to below 30 percent in 2005. Morale has followed a similar downward path but has plummeted even further, falling to under 15 percent by 2005 (Comstock 2005).

One of the major effects of this latest round of concession negotiations is that the dates when many of these agreements become amendable have converged, both within and across carriers. A major question on the minds of both our research team and many in the industry is what will happen when these agreements come up for renegotiation: Will labor and management have repaired the low morale and distrust and have engaged the skills and motivation of the workforce in efforts to reverse the losses of recent years? Will the industry have recovered? Will employees have shared in the recovery in a way they believe is equitable? If not, we would expect very strong pressures from the workforce to make up for the ground lost in the interim.

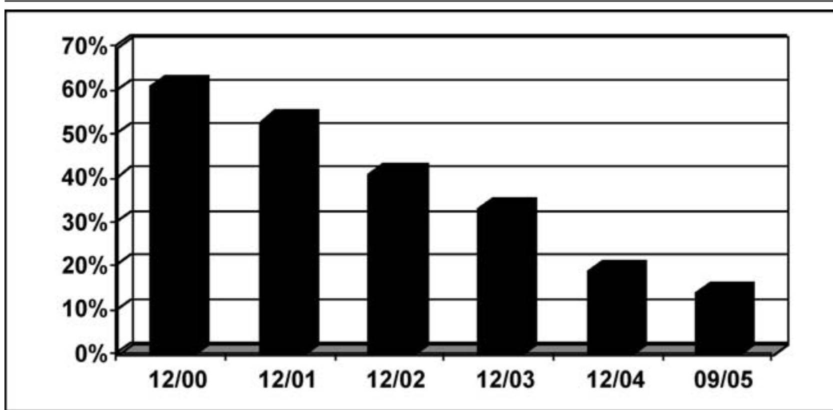
Despite the fact that a general convergence of labor costs is occurring in the

FIGURE 4
Positive Views of How Management Is Running the Airline



Source: The Wilson Center for Public Research, Inc.—based on 150,674 interviews conducted with pilots or flight attendants from 1/1/2001 to 9/20/2005. The specific question reads as follows: How would you describe, in your own view, how [company name's] management is running the company."

FIGURE 5
Positive Views of Employee Morale



Source: The Wilson Center for Public Research, Inc.—based on 150,674 interviews conducted with pilots or flight attendants from 1/1/2001 to 9/20/2005. The specific question read as follows: "How would you describe, in your own words, the pilot [flight attendant] group's morale?"

U.S. industry, to date we have observed little change in the arms-length status quo relationships in the firms now attempting to emerge out of bankruptcy. While all of the parties have discussed the need to improve relations, and some such as Delta and Delta's pilots have included language committing to implementing a "recovery compact," to date there is little movement to observe in this direction. Northwest pilots have expressed interest in exploring this option as well; however, it is not yet known whether this is a feasible option in working with Northwest management or in the context of the deep frustration and distrust apparent among pilots at this company and across the legacy carriers.

In contrast, American and Continental have taken different approaches. Both have, to date, avoided filing for bankruptcy and have negotiated smaller wage and benefit concessions than the four carriers in bankruptcy. Continental has worked hard to continue its decade-long commitment to building and maintaining positive employee relations. Part of the concession agreement at American called for the parties to work together to improve productivity, customer service, and morale. Its efforts were set back in early 2006, however, with the announcement that senior executives would be receiving bonuses that union leaders and the workforce felt violated both the spirit and the letter of their prior commitment to hold executive compensation increases to the same standards as the rest of the workforce. Efforts have been restarted with the mechanics' union and are reported to have achieved significant productivity improvements. Time will tell whether the efforts at Continental and American will provide

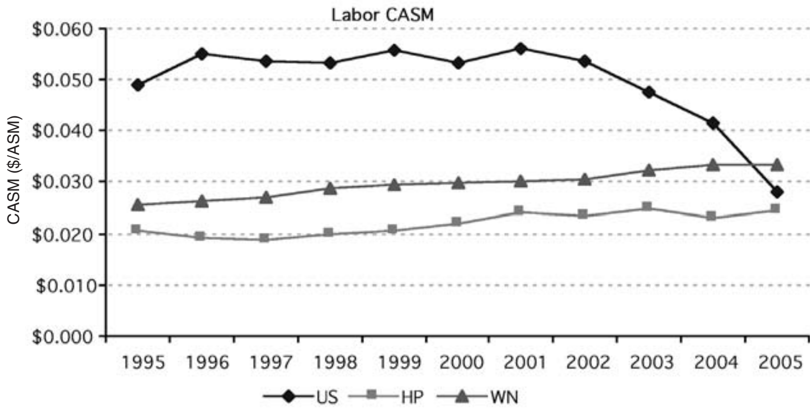
the productivity and customer service improvements needed to give them the competitive advantages they believe will help achieve a sustained recovery.

Southwest, as is well known, is the quintessential low-cost airline, albeit one that has consistently followed a set of human resource and labor relations strategies that produce high levels of employee satisfaction, commitment, and engagement in productivity enhancing behaviors (Gittell 2003) and positive labor management relations as indicated by the speed and low levels of conflict experienced in collective bargaining (vonNordenflycht and Kochan 2003). While Southwest continues to maintain these strategies, the gap between Southwest's labor costs and other carriers has closed considerably; the effects of the concessions at the legacy carriers now puts Southwest Labor CASM at about the same point as the average of the legacy carriers.

Indeed, as figure 6 indicates, US Airways, historically one of the highest-cost airlines in the United States, has negotiated large enough concessions to bring its labor costs down below those of Southwest. As predicted, in doing so, its employee relations have become significantly more stressed and adversarial. At the moment the company (now merged with America West) is in negotiations with both its pilots and flight attendants over how to integrate contracts from the two merged entities. To date, the process has been difficult, with the company favoring the lower-cost contract provisions for both groups and the unions proposing to bring up the lower wage and benefit provisions to the standards of the higher contracts in the prior organizations. The recently announced bid by US Airways to purchase and merge with Delta appears to have changed management's strategy; management recognizes that it will need to accept the higher wage standards in its merged agreements. Clearly more challenges lie ahead as the company works on integrating the labor agreements, employment practices, and cultures of the two (or three) merged organizations.

In the meantime, Southwest has moved into some of the larger airport markets, such as Baltimore and Philadelphia, where US Airways has held significant market share. This requires it to compete head-to-head with US Airways on a number of routes. In figures 7 and 8 we present data on market share trends between US Airways and Southwest in the largest seventeen routes in which the two companies now compete. As can be seen, Southwest has steadily gained market share in these markets, largely at the expense of US Airways. Most of this shift in market share occurred, however, over the period of time that Southwest enjoyed a significant labor cost differential vis a vis US Airways. The obviously interesting question is what happens going forward now that the labor cost gap has largely closed. Since, to date, there appears to be little change in the positive labor-management relationship that Southwest has experienced over its history, and given the tensions and

FIGURE 6
Labor Costs Comparisons: Southwest, US Airways, and American West



US=US Airways, HP=America West, WN=Southwest

uncertainty over labor-management issues that continue at US Airways, our prediction is that the trends may slow somewhat but will continue.

The prospect of further consolidation of airline firms in the United States adds more uncertainty to the future of the industry's business and employment relations systems. As of this writing, US Airways has made a hostile bid for Delta. Continental is in talks with United. Airtran has made a hostile bid to purchase Midwest Airlines. More such consolidation bids are likely to come, mixing higher- and lower-cost airlines and airlines that have distinctively different labor and employment relations histories and contemporary features. Combining airlines with diverse cultures and employment relations practices is always a difficult process. Doing so when it involves an unsolicited and unwanted merger is likely to make it more difficult to generate comparative advantages from the merged employment relations system.

Developments outside the United States

Data on labor and unit cost trends in other parts of the world are still being assembled as part of our overall project. Here we will discuss some preliminary evidence from our colleagues' case studies. The case data suggest some narrowing of costs and competitive dynamics similar to those occurring in the United States are playing out around the world.

The comparison of Ryanair and Aer Lingus is especially informative. A statistical study of ten low-cost carriers in the United States and Europe concluded that Ryanair "has the most similar operating and product features to the original low-cost model, and also recorded the highest operating margin

FIGURE 7
Aggregate Market Share in 17 Markets

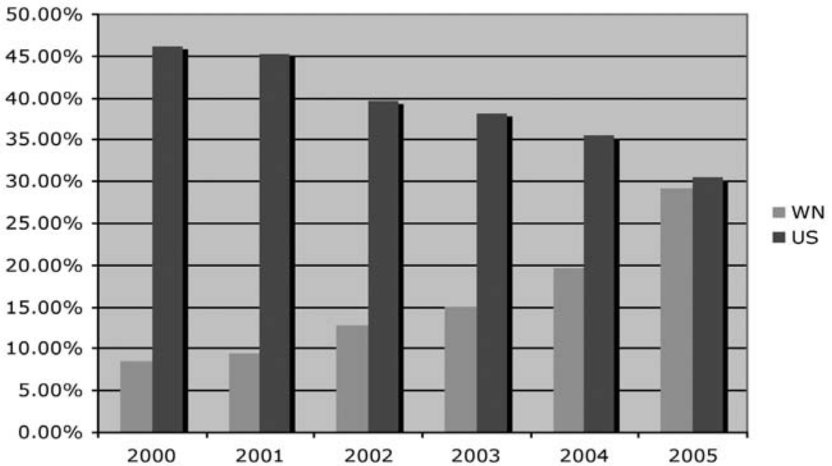
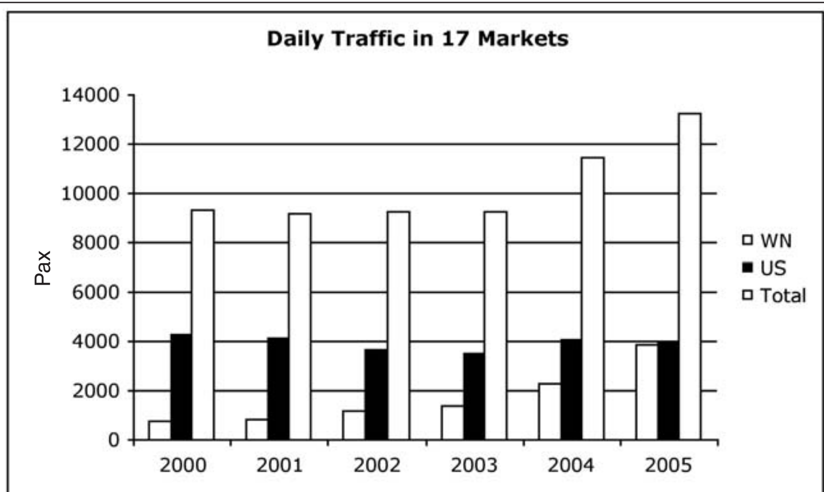


FIGURE 8



of the 10 selected carriers" (Alamdari and Fagan 2005: 390). The bottom line performance of Ryanair continues to be extraordinarily impressive. Witness, for example, the following statistics (Pate and Beaumont 2006: 323):

- In the fiscal year to March 2004, revenue totalled $1.32 billion, which was up 44% on the previous year

- In the period 2000–2004 unit costs were cut by more than 20% (they are 70% lower than the average of the 3 major carriers in Europe)
- They are filling planes up to 80–85% of capacity (their breakeven point is at c. 63% of capacity)
- 16% of total revenue comes from sources such as credit card fees, hotel or rental car bookings, and retail sales, all of which involve relatively high margins

The Ryanair strategy for achieving low costs has been and continues to be fundamentally different than that of Southwest. Pate and Beaumont (2006: 324) report the major employee relations disputes and complaints that have arisen at Ryanair in the period 2000–2006. One simple example can provide a feel for the situation there; in mid-2005 a dispute arose when the company attempted to persuade pilots to accept a new training offer, which included the clause that pilots would have to pay back 15,000 euros of training costs if they left the airline within five years or if Ryanair was compelled to engage in collective bargaining with any trade union.

Ryanair has been very prominent in the media recently with its attempted takeover bid for Aer Lingus, the former national carrier in Ireland. Given Ryanair's employment relations' reputation, it is not surprising that Aer Lingus employees have voted overwhelmingly to oppose this takeover.

Aer Lingus is itself arguably the most instructive example in Europe of a conventional carrier engaged in the process of "de-frilling" in order to stem the loss of market share to Ryanair and other low-cost competitors. The details of this process are reported in Wallace, Tiernan, and White (2006); there has been considerable short-term bottom line success. Aer Lingus's current operating margin of 8.2 percent is nearly double the EU average (4.2 percent) for conventional carriers. As per one of our preliminary predictions stated above, this bottom line success has involved something of a trade-off in terms of workforce attitudes and behavior. Recent years have seen major employee and union disputes over company proposals for compulsory redundancies, changes to the pension scheme and staffing levels, and largely unsuccessful attempts to develop a management-labor partnership. The result has been an extremely heavy involvement of government and third-party institutions in seeking to resolve these and other disputes (Turnbull, Blyton, and Harvey 2004).

An interesting contrast to Ryanair can be seen in the case of easyJet, a rapidly growing and highly successful British-based low-cost airline. easyJet also modelled its start-up business strategies on Southwest, focusing on a single aircraft, electronic ticketing, etc. But unlike Ryanair it has focused on growing revenue rather than squeezing the last ounce of costs out of the system and its employees. As Pate and Beaumont (2006) indicate, easyJet uses tight performance manage-

ment system principles to reward employees and managers for meeting clear financial and operational performance objectives; it has now accepted unions (following the introduction of the British Employment Relations Act of 1999 and the statutory procedure for union recognition) but keeps them largely at arms length rather than embracing them as partners in operating the business. Its rapid growth and strong profit record indicate there is room for more than one approach to competing in the low-cost sector. As it evolves, however, easyJet is beginning to recognize its business model must evolve to improve customer service and to attract more business customers, thereby requiring a higher level of commitment and engagement of its employees. This is clearly lacking among some employee groups, most notably pilots.

Based on the experience of British Airways (BA), the strategy of legacy carriers establishing their own low-cost subsidiaries may backfire. When BA established Go, a low-cost subsidiary that would compete with easyJet and other low-cost airlines, this added "legitimacy" to the low-cost market. Moreover, the "low frills" strategy of Go, as opposed to the "no frills" strategy of Ryanair and easyJet, took market share from BA, especially in the lucrative business market. Go was eventually taken over by easyJet, illustrating that there is very little room in the U.K. market for more than a few major low-cost airlines, at least those that intend to compete directly for market share with the legacy carriers as opposed to creating new routes from secondary airports that do not impinge on the (hub-and-spoke) route network of the major European flag carriers (Harvey and Turnbull 2006).

BA's foray into the low-cost airline business highlighted three important lessons for European legacy carriers. The first was just how price elastic demand for air travel could prove to be, leading to more effective yield management strategies. The second was how full service carriers could reduce costs without undermining service quality, largely through the more effective utilization of equipment and by "borrowing" some of the cost-cutting initiatives of the low-cost airlines (for example, internet bookings and "ticket-less travel"). BA's profitability in recent years, for example, owes more to the improved utilization of resources—including human resources—than new service initiatives. Third, while BA was able to launch a successful low-cost airline in the "permissive" industrial relations climate of the United Kingdom, it was unable to make its low-cost strategy work in continental Europe (for example, Deutsche BA in Germany and Air Liberte in France), where the industrial relations system imposes significant "constraints" on the low-cost model. In particular, works councils, systems of co-determination, and expectations of social partnership limit the ability of airlines to achieve low costs at the expense of labor, which is the core of the more extreme low-cost strategy epitomized by Ryanair. For the legacy carriers, however, (micro) corporatist forms of social partnership can

act as a "beneficial" constraint (Streeck 1997), creating a degree of stability for management-labor relations in an industry that is prone to the negative effects of pro-cyclical demand and consequent attempts to "repair" trust and "rebuild" morale, which airlines seem prone to destroy or undermine in their drive to cut costs (see Bruch and Sattelberger 2001; Turnbull et al. 2004). Unlike the United States and the United Kingdom, where human resource management issues and labor relations are all too often "secondary" or "subsequent to" the determination of the airlines' business strategy, these matters are dealt with at source and in conjunction with business strategy under the industrial relations systems that tend to prevail in much of continental western Europe.

Despite BA's experience with Go, in Australia Qantas has created Jetstar as a low-cost airline within the Qantas company to compete with the rapid rise of Virgin Blue, a stand-alone, low-cost airline that had started in 1999. Qantas and especially Jetstar are invoking the radical post-2005 Australian industrial relations legislation as a means of substituting bargaining with separate unions with more flexibility in their relationships with employees. The growth of Virgin Blue and Jetstar has increased pressures on Qantas employees and unions (Bamber et al. 2006). The option of allocating routes and jobs to Jetstar, the low-cost arm of Qantas, serves as a highly visible threat to Qantas unions and employees. As Jetstar and Virgin Blue expand into Asian, trans-Tasman, and trans-Pacific routes, the original lines of demarcation (the low-cost carriers handling domestic leisure travel, leaving Qantas to handle business and international travel) begin to blur. Again we see a convergence into shared and potentially crowded competitive space.

This brief and preliminary survey of developments outside the United States illustrates a similar movement toward the middle in competitive strategies but significant variation in the employment strategies and practices within both legacy and new entrant firms. Given this convergence on strategic dimensions and variation on employment system variations, "low cost" may no longer be an accurate label for the new entrants.

Some Tentative Conclusions: More Change to Come

To say that offering "conclusions" about the state and future of the global airline industry is akin to shooting at a moving target is an understatement. Clearly the dynamic set off by the emergence and growth of new competitors that began with lower costs will continue to play out around the world. Potential consolidations/mergers will add further uncertainty. But some preliminary thoughts, not conclusions, can be offered.

- Southwest clearly has been the benchmark, with nearly all start-up airlines adapting selected parts of its business and employment rela-

tions model. The business model it pioneered has been replicated or adapted to work in Ireland, Britain, continental Europe, Australia, and Asia. So, too, have many of the features of its human resource system with emphasis on coordination, performance management incentives, and high levels of employee motivation and commitment. Southwest's partnership approach to labor relations has been adapted by some to fit different national institutional and legal contexts. In Europe and Australia stronger labor legislation and a stronger union presence require acceptance of unions. The role of unions in the newer firms such as easyJet, Jetstar, and Virgin Blue seems to be more limited, however, than the European interpretation of "social partnership" would imply. In starker contrast, Jet Blue and Ryanair have rejected the Southwest labor relations model in favor of efforts to remain non-union. Ryanair has followed a classic union suppression strategy; Jet Blue has followed a classic union substitution strategy. Overall, we might argue that start-up airlines in other countries seem to have learned more from Southwest than most of the legacy airline companies in the United States.

- There is movement toward a more common, contested competitive space as legacy carriers cut their labor costs through hard bargaining and/or unilateral actions and as the low-cost entrants come of age and seek to expand their customer base and market segments. As more head-to-head competition ensues, we might expect more consolidation.
- There is growing heterogeneity within both the low-cost and legacy industry segments, perhaps to the point that these labels no longer do justice to the firms in each sector. A new and more dynamic taxonomy may be needed. Within what has been referred to as the low-cost sector we might distinguish between those firms such as Ryanair that remain focused on competing by being the lowest-cost competitor and those that are seeking to maintain a cost advantage but balance it with efforts to grow their revenues by expanding into higher yield business and international markets (for example, Virgin Blue). Doing so will require bringing the workforce along through more positive human resource policies and practices and labor relations strategies that at a minimum achieve labor peace and avoid rapid increases in labor costs (wages and staffing).
- Within the so-called legacy carriers we see heterogeneity as well with some tending to either ignore or at least not seem eager to go beyond lowering labor costs and begin rebuilding trust and positive labor management relations, while others have taken a more limited approach to wage and benefit cuts and are taking steps to restore or maintain trust and positive labor-management relationships. European legacy carriers

have taken a parallel approach to adapting their strategies and their employment relations practices than the more sequential approach observed in the United States. Which of these two strategies will succeed will not be known until the concessionary labor agreements come due for renewal negotiations. At that point pressures from the workforce will reflect the treatment and the sense of fairness or unfairness experienced in the interim years.

- Cutting through the complexity, however, there is one undeniable fact that characterizes the new employment system in airlines. Wages, benefits, working conditions, and labor standards have been ratcheted down. Most airline employees are working harder, longer, and for relatively less pay and benefits than did their counterparts of an earlier generation. They have borne the brunt of the radical transformation occurring in this industry. Customers who value low prices have been the big beneficiaries in this transition period. Most shareholders have also fared quite well as new start-ups share prices have taken off and analysts have bid up legacy carrier share prices, largely on speculation over which firms might be taken over and which will survive the on-going consolidation. Attorneys and investment bankers who thrive on bankruptcy and merger business have also prospered. Whether there will be an employee backlash that seeks to recapture some of their lost ground remains to be seen. Whether employees can do so even if they try is an even more questionable proposition.
- What we can say with certainty is that the global industry is not at some steady state of equilibrium. More changes are yet to come, some perhaps will have occurred before the print on these pages is dry.

Acknowledgements

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