Bloomberg Businessweek

Magazine

Why American Airlines Is Stuck at the Gate

Posted on October 07, 2010
http://www.businessweek.com/magazine/content/10_42/b4199019823300.htm

For much of the past decade, U.S. airlines have scrambled to remake themselves. United Airlines (UAUA), Delta Air Lines (DAL), US Airways Group (LCC), and Northwest Airlines all made trips through bankruptcy court and emerged with trimmer operating and labor costs. Then many carriers went into acquisition mode. Delta snapped up Northwest in 2008, United this month completed its takeover of Continental Airlines, and on Sept. 27 Southwest Airlines (LUV) said it will buy AirTran (AAI).

Through it all, AMR's (AMR) American Airlines looked healthy enough to go it alone. Once the global leader, the Fort Worth-based carrier managed to avoid bankruptcy. Now, as other airlines recover, American is paying the price for sidestepping the near-death experiences of its competitors. It's bleeding red ink. Its stock price has dropped 20 percent this year, the only decline among the six biggest U.S. carriers. And its pretax margin in the first half was -4.3 percent, the only negative among its peers. "They're playing the hand they were dealt by avoiding bankruptcy," says Stifel Nicolaus analyst Hunter Keay. "It's unfortunately costing them dearly."

Labor costs remain the big challenge. Of the almost 50,000 workers represented by unions at American, only a group of 90 technical specialists has approved a new contract. The carrier has been negotiating with its pilots for more than four years, while its flight attendants, airport ground workers, and mechanics have been in contract talks for more than two.

A continuing obstacle to labor agreements is the $1.6 billion in annual concessions the unions agreed to in 2003 to help keep the carrier from seeking bankruptcy protection. Filing for Chapter 11 protection would have allowed American to alter its labor accords unilaterally. Workers want the airline to restore at least some of the concessions. Management says that on labor costs alone, the carrier is still at a $600 million-a-year disadvantage to rivals. "It's a big brick in our backpack to being competitive in this industry," says Senior Vice-President Jeff Brundage.

The Transport Workers Union scrubbed a tentative accord for 10,600 baggage handlers and ramp workers in June. Mechanics and stock clerks rejected a three-year contract in August and authorized TWU leaders to call a walkout among their 12,700 members.

It's much the same with flight crews. About 9,600 American pilots are working at 1993 hourly rates, leaving them with "massive anger and frustration" over a lack of progress in the talks, says David Bates, president of the Allied Pilots Assn. Adds Laura Glading, president of the Association of Professional Flight Attendants, which has 16,550 active-duty members at the carrier: "You can't come to labor and keep taking and taking and taking." Glading will meet with a federal mediator on Oct. 19 to press a union request that bargaining be declared at a stalemate, which could trigger a countdown toward a strike, the first at a big U.S. airline since 2005.

American has said liberalizing work rules would allow it to increase wages while keeping its current cost structure. Studies show the airline is at or near the bottom of the industry in productivity, says Jerry Glass, president of F&H Solutions Group and a former US Airways labor executive. Says Stifel

Nicolaus' Keay: "It's critically important that the labor groups understand that work rules are what is preventing American from reporting profits in 2010 to a large degree."

American faces operational challenges as well. To counter a possible loss of corporate accounts to rivals who are adding routes through mergers, Chief Executive Officer Gerard Arpey is trying to expand pricing alliances with carriers outside the U.S. Those partnerships allow airlines to share revenue, marketing expenses, and frequent-flier programs. Adding more foreign partners lets American capture a bigger share of high-fare international business travelers.

Arpey also is adding flights at hubs in five domestic markets used heavily by business travelers: New York, Los Angeles, Chicago, Dallas-Fort Worth, and Miami. By early 2011, 98 percent of American's available seats will touch those hubs, up from 88 percent a few years ago. American expects by the end of 2012 to have $500 million in annual revenue and savings from its international partnerships and the intensified focus on servicing business travel hubs. Still, counting fuel, labor, and other expenses, American's cost to fly each seat a mile in 2010's first half was 12.76 cents, the most among the six biggest U.S. carriers, based on data compiled by Bloomberg.

Part of the financial drag comes from American's Boeing (BA) MD-80 jets, which make up the largest part of its 619-plane fleet. While they're slowly being replaced by Boeing 737s that are about 35 percent more fuel-efficient for each seat flown a mile, the MD-80s still account for about 40 percent of American's big jets and won't all be retired until about 2016 at the current replacement rate.

Those changes are unlikely to make up for the high labor costs. "The changes they are making in their flying are going to help," says James M. Higgins, an analyst at Soleil Securities. "For me, they're all completely dwarfed by labor and the question about what's going to happen there."

The bottom line: *American Airlines, once the nation's largest carrier, has fallen behind competitors because of high costs locked in by not seeking bankruptcy.*