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Into Thin Air

By ROGER LOWENSTEIN

In the evening of Sept. 10, negotiators for the C.E.O. of United Airlines, James Goodwin, huddled in Washington with union officials representing United's 30,000 baggage handlers, customer-service representatives and reservation agents. They were putting the finishing touches on an agreement for a hefty double-digit wage increase, and Goodwin, a tall, likable West Virginian who had been with the company 34 years, was waiting for a call to give his O.K. It didn't matter that United, which had lost \$605 million in the first half of 2001, was in a financial tailspin: when airline unions are due for a raise, they get one. If you don't understand why, then you don't understand the airline business.

As it happened, the talks dragged on, and at 5:30 on the morning of the 11th, the negotiators trudged off to get a few winks. Randy Canale, a union negotiator, returned to his hotel, the Capital Hilton, not far from the Pentagon, figuring they would sign later that day. He awoke earlier than expected, to the sound of sirens. "Boy, it sounds awful close," Canale murmured. Someone was banging on his door, and puffs of smoke were visible from the hotel window. Two of United's jets were down, the wage hike was history and so was the 57-year-old Goodwin's career. Seven weeks later, he was dismissed by United's board. It hardly mattered that United's directors would have approved the agreement and were as much to blame as Goodwin. They were letting him go for a way of doing business that has tormented United and the entire industry for decades.

Since 1978, when commercial aviation was deregulated, no fewer than 137 carriers have filed for bankruptcy protection. And from the end of World War II, when aviation started to become big business, through 1994, the sum of the industry's profits and losses was less than zero. Warren E. Buffett once remarked that it would have been a blessing for shareholders if someone had thought to shoot down Orville Wright at Kitty Hawk.

This is the industry that Congress has rushed to save, and this is the record that -- failing basic changes -- it will have helped to perpetuate. Indeed, even as it reels from last year's record \$3.8 billion operating loss, United is facing the possibility of a strike by its mechanics, pending a vote on a proposed 37 percent wage hike this past week. If this rings faintly of "Alice in Wonderland," well, that is because airlines are not like other businesses, where competition breeds variety and choice for consumers and profits for business. They are more like flying utilities. As passengers, we demand quality service -- on-time takeoffs,

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edible food, plenty of leg room -- and don't much care who provides it, as long as they make it cheap. That leaves the airlines with the dubious honor of competing to be the Ma Bell, the Con Ed, of the sky.

One reason the major airlines find themselves in this predicament is that they use huge amounts of fixed capital -- wide-body jets go for \$100 million each and can't be readily liquidated. They also depend on a skilled labor force. The two problems exacerbate each other. Since airlines cannot afford to let planes sit idle, they can ill suffer strikes. That makes their unions unusually powerful. Consider some other businesses for a moment: Microsoft has highly skilled programmers but little invested capital. Merrill Lynch has both, but its assets -- stocks and bonds mostly -- could be liquidated overnight. Steel has high fixed capital, but it can replace its workers more easily.

Airline pilots (and mechanics too) are not so replaceable. Stringent safety codes strengthen the unions further by introducing a stickiness into the rules that govern hiring and firing. Any other industry would compensate by raising fares, but air travel is a commodity, so the temptation is always to cut fares to fill seats.

None of this was caused by the attack on the World Trade Center. But until then, it was possible to believe that airlines were turning a corner. Even though they were losing money in 2001, they had recently enjoyed some good years, thanks to genuine improvements in their operations. They had learned to manage their fleets more efficiently, they had structured their routes better and they had cut overhead.

United was emblematic of the airlines' ephemeral prosperity. In the late 1990's, it reported \$4 billion in profits, and its route map, stretching over four continents, was the envy of the industry. Most strikingly, it had ventured a daring solution to the industry's thorniest problem -- labor -- by selling a majority of its stock to its employees.

But despite this groundbreaking arrangement, United was never able to fully align the interests of its employees, particularly the pilots, with its own. Rick Dubinsky, longtime head of the AirLine Pilots Association at United, made this clear when he and Goodwin began a recent wage negotiation. "We don't want to kill the golden goose," Dubinsky told Goodwin. "We just want to choke it by the neck until it gives us every last egg."

On Sept. 11, the goose ran out of eggs.

In five months, United's traffic has shrunk by, on average, a quarter, fares are down and two of its fleets lie mothballed in the middle of the Mojave Desert.

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Meanwhile, it has been begging senior pilots, who can earn close to \$300,000 a year, to sit home and collect a full 80 percent of their pay for doing nothing; otherwise, they can remain on the premises, though inactive, at full pay. This is why by the end of 2002 United stands to lose every penny it made in the previous five years -- and why bankruptcy for one of the nation's largest and most venerable airlines looms as a real possibility.

United's modern history started in 1985, when Richard Ferris, the C.E.O. at the time, boldly challenged his pilots. The underlying issue -- then, and in every subsequent dispute -- was management's desire to break the contractual stranglehold inherited from regulation. Before 1978, fares were set by the Civil Aeronautics Board, which generally let carriers pass along their costs. Such a cozy set-up naturally bred inefficiency (banks were similarly slothful in the days of managed interest rates), and airlines got used to rubber-stamping union demands. Eventually, they approved a byzantine system of work rules sought by pilots and other employees. Come deregulation, competition intensified, air fares dropped and more people started flying. But the stifling work rules remained and so, of course, did safety constraints and also antitrust concerns preventing mergers. In effect, aviation became deregulated only on one side: free competition for revenue; costs largely immovable.

Ferris tried to win points by befriending the pilots. He started flying, got a license and took some union members under his wing. For a while, it worked. Attacking a brazen case of featherbedding, he got the union to agree to cut the number of pilots in the cockpits of Boeing 737's from three to two. But when he tried to impose a lower wage scale for newly hired pilots -- as Robert Crandall had done at American -- the pilots went on strike.

The head of the union's strike committee, Dubinsky, was nicknamed Mad Dog. The son of a butcher, he was hired by United in 1965 at a measly \$500 a month. He flew the tobacco route: Winston-Salem, Raleigh-Durham, Chattanooga. In the pilot culture of the day, captains were virtual gods and young flight engineers like Dubinsky received barely more respect than the stewardesses. Dubinsky, though, found a vent for his aggressiveness. He started doing small chores for the AirLine Pilots Association and then handling grievances, and the union discovered that he was a badger. By 1985, he was brimming with class-conscious fervor. The pilots, despite their political conservatism and sense of themselves as professional people, heeded him. Pilots make good money but lack the free agency of other professionals. If a United pilot moves to Delta or American, he loses his seniority and most of his pay. That makes him utterly dependent on the union -- and makes the union a potent force.

Ferris hired replacements to keep United flying, and the pilots returned after 29 days, taking the offer Ferris had on the table. The strike was over, but

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permanent damage had been done. A certain culture, an implacable Arab-Israeli-like hatred, took hold at the airline, and nobody has been able to dislodge it since. More significant, United's experience helped spread fear through the industry. Airlines began to leapfrog one another, granting successively better terms at each negotiation -- anything to avoid a strike.

Today, thanks to generous vacations, sick-leave provisions and clauses that fix minimums for days worked and trips flown, United pilots get paid for 81 hours a month but actually fly, on average, only 50 hours. Considering that a Boeing 747-400 captain gets a top rate of \$302 an hour, you can see what a drain this is. Though pilots spend many nights away from home, a hardship that is worth some extra compensation, they freely admit that flying, on most days, is hardly the risky proposition it was when the first contracts were penned. "It's not a hard job for a guy that has been around," says one 40-year-old United pilot I talked to. "Because of advances in technology, we have great airplanes to fly." Their flexible schedules allow many pilots to carry on second careers.

By 1986, Ferris decided that United couldn't make money just flying planes. So he stitched together a hotel and car-rental conglomerate, aiming to use the airline to feed the travel businesses -- synergy! He paid a consultant \$7 million to rename United's parent the Allegis Corporation. Wall Street snickered. The pilots did not. They feared that Ferris would divert capital into the other divisions until the airline was a rump operation and then start cutting jobs.

The ALPA adviser was the illustrious F. Lee Bailey, and he told them that their jobs would never be safe unless they really took control -- a message that the pilots, being pilots, were happy to hear. Dubinsky and Bailey flew to Chicago to meet with a leader of the International Association of Machinists and dropped a proposal for an employee buyout into his lap.

The machinists didn't like it. Presciently, they saw the plan as leaving workers to bargain with themselves, an obvious conflict. But Dubinsky made his bid public. It was a strange time on Wall Street, in which anybody could seemingly acquire anyone else and companies were said to be worth more dead than alive. Coniston Partners, a hedge fund, bought a chunk of stock and agitated for a breakup. The board, feeling pressured, sacked Ferris and agreed to sell the travel assets. Stephen Wolf, a veteran of two previous airline turnarounds, was named C.E.O. late in 1987.

After briefly joining with ALPA to attempt a high-priced buyout (which, when it failed, set off the stock-market crash of October 1989), Wolf embarked on an expansion kick, snatching up international routes and ordering \$22 billion worth of equipment. His competitors followed suit. Since wages rise sharply with experience, airlines were desperate to hire younger crews. "So how do you get

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more new pilots?" says Harry C. Pinson, an investment banker who worked with Wolf. "You grow the airline."

The logic was so compelling that airlines bought many more planes than they needed. In aviation, such capital mistakes don't go away. Equipment is so expensive that once a plane is delivered it must be flown. Even carriers that file for bankruptcy limp along for years, usually operating at lower costs and undercutting the rest.

Wolf discovered this in 1990, when conflict in the Mideast and a recession at home (sound familiar?) sent the industry into a nose dive. Making matters worse, Southwest, then a relative upstart, was tormenting the industry and, in particular, stealing United's traffic in California.

As losses mounted, Wolf clamored for union givebacks. He and Dubinsky began to shadowbox. When United ordered new 747's, a dispute with the pilots' union kept them parked on a ramp. When United tried to start service to India, the pilots delayed it by demanding private restrooms and Western food. Dubinsky kept up the pressure, but his time was running out. His term at ALPA expired. (He lost an effort to rescind a term-limits clause and wrote an acid farewell remembered within the union as "the Nixon letter.") Wolf, a tall, aloof C.E.O. who arrived at United's headquarters near O'Hare Airport at 6 each morning, seized the opportunity. He sold off the flight kitchens, which made the machinists fear that their jobs would be next. Then, with their cooperation, Wolf and the pilots, now led by Roger Hall, a less tempestuous chief, cobbled together an audacious employee stock-ownership plan.

Similar ideas had been tried at Northwest and Eastern, but never with workers in control -- that was what bred such hope at United. The pilots, machinists and nonunion salaried employees (the flight attendants opted out) got three board directors, various control provisions and, critically, 55 percent of the stock. The pilots, the biggest bloc, got 25 percent, in exchange for an equivalent percentage cut in wages and benefits.

A new era of worker-management cooperation was born. Optimism ran high. Robert Reich, the secretary of labor in the Clinton administration, gushed that the employee-ownership plan "could change the face of the airline industry." But there was one devastating oversight: yes, you could turn employees into owners, but could you get them to act that way? Could you get them to place the same value on their stock as on their weekly paychecks?

The difficulty, as Dubinsky would shrewdly observe when he was back battling United management, is that "you can't eat stock" -- particularly when employees were barred from selling their shares until retirement. In any case, airlines had

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never generated value for their stockholders. Donald Washburn, a former executive at Northwest Airlines, has observed that airlines are merely "cash accumulators for other constituencies" -- the various government entities that tax it, the cartel that sells it equipment and the industry's bankers. Its hungriest constituent is labor, which gobbles up nearly 40 percent of operating expenses. The employee buyout temporarily lowered wages, but it didn't change these dismal economics. Arguably, it weakened United. The pilots had always sought control; now they could pursue it from inside the boardroom.

As owners, the pilots could pick their own C.E.O., and they did: Gerald Greenwald, famed for helping save Chrysler and fresh from running a trucking concern in newly capitalist Czechoslovakia. When Greenwald told his Czech managers that he was leaving to take over the new worker-owned United, one of them stared incredulously. "We just finished with all that," he said.

Greenwald figured that with workers owning a stake, their interests would have to shift. So he invited pilots and mechanics into strategy sessions and consulted with Fortune to learn how to qualify for the magazine's list of 100 most desirable companies to work for.

Many pilots caught the spirit. Absenteeism declined. A captain in Chicago cleaned food trays to shorten turnaround times. And miraculously the good times started to roll. United's stock, \$22 when the ownership plan began, broke \$90 three years later. (Today it is \$12.) Partly, airlines were the beneficiaries of good fortune: fuel prices were low and the economy was strong. But they also had learned to be more efficient, eliminating frills, reducing commissions to travel agents, reaping savings from automatic check-in. Unlike in the previous decade, most avoided the trap of overexpanding. Greenwald strengthened his hubs and eliminated unprofitable, marginal routes. He also enhanced United's unmatched network overseas. These were heady days for the big airlines, as they finally capitalized on the promises of deregulation.

Except for one little thing. They still could not keep wages under control.

Through the 90's, airline wages rose 43 percent, just slightly above inflation. Not bad until you consider that air fares rose only 6 percent. This was, significantly, a time when other industries were holding the line on every conceivable employee benefit. Only the airline industry, shackled by 40-year traditions, continued to kneel to its unions. The regional airlines are a perfect illustration. These carriers, like American Eagle or United Express, fly under the majors' flags and serve an essential role connecting smaller cities to hubs. They also pay their pilots, most of whom are represented by ALPA, significantly lower wages. The business has grown smartly, thanks to a new generation of high-performance jets, but the

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unions don't like these smaller planes and the lower wages that go with them, so they have successfully negotiated "scope clauses" that limit the size and number of regional jets that a major can hire out.

If it were up to the market, a new-generation, 50-seat Canadair might fly from New York to Chicago at off hours, when there wasn't demand for a DC-9 or a Boeing 737. Presumably, that would result in more flexibility and choice for customers. But scope clauses, a bit of protectionism that seems wildly out of place in the 21st century, make it extremely difficult.

With their hands tied on costs, airlines turned their attention to revenues. In the 90's, they perfected the art of "yield management," exploiting computers to monitor bookings continuously and adjust ticket prices according to availability. Yield management is why you can pay \$1,000 to fly coast to coast and sit next to someone who paid \$200. It is also why so many people hate the airlines.

It may seem unfair, but to an airline economist, the passenger -- say a student heading home for the holidays -- who books in advance and the executive who sidles up to the counter without a reservation are not buying the same "product," even if they are on the same flight. One is buying a surplus seat, akin to last year's sweater on the bargain rack. The other is buying that sweater when it's hot.

It is a good business tactic, but the airlines overplayed it. During the late 90's, they jacked up the premium for business fares as never before. I.P.O. money rained on Wall Street, and plenty of it got spent on plane tickets. United's San Francisco hub, a gateway to Silicon Valley, became a gold mine.

Airline unions exploited the boom to demand higher wages, but the good times for airlines -- flying utilities, remember? -- were never good enough. In one recent year, carriers filled 72.4 percent of their seats, just a tad more than their break-even level of 70.4 percent. What this means is that on a typical flight, the entire profit was generated by the last three passengers. From 1995 to 1999, the industry's best half-decade ever, airlines earned only 3 1/2 cents on every dollar of sales, whereas American industry typically earns 6 cents. And through the full cycle -- that is, for all of the 1990's -- airlines made less than a pitiable penny for every dollar of sales.

If this were another industry, C.E.O.'s would be forced to resign in disgrace, but airline execs were buoyed. At United, Greenwald gave the pilots and machinists consecutive 5 percent wage hikes, the maximum allowed by the terms of the ownership plan. Then the unions demanded a "snap back" to take effect in 2000, restoring them to pre-ownership levels. Greenwald consented and, remarkably, so did United's board. It may be unkind to say the company lived in fear of

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upsetting its employees, but everyone, especially at United, knew what the unions were capable of doing.

Meanwhile, management's relations with the AirLine Pilots Association deteriorated. As Greenwald neared retirement from United in 1999, the union nixed his choice of successor; instead, the pilots tapped Goodwin, a company man that many deemed controllable. As negotiations started for the first post-ownership contract, the drumbeat rose for a more confrontational approach -- rose, that is, for Dubinsky. The rank and file were mostly unaware that while out of office, Dubinsky had been busy suing his own union. He would soon collect a six-figure settlement paid from his pilots' dues. No matter. With a big negotiation looming, the union's 26-member governing body voted him in.

United's pilots were counting on a contract by April 2000, when the ownership plan expired. The deadline was unrealistic, and it gave Dubinsky a cudgel to wield against the company. Goodwin compounded his problem when, late in 1999, he and Wolf -- who was now running US Airways -- began to plot a merger. The timing was suicidal.

Dubinsky, as a board member, was informed of the talks but could not disclose them to the rank and file. He certainly knew the pilots would oppose a merger, because many would lose seniority to US Airways pilots. Thus, Dubinsky had every reason not to conclude a contract until the merger was announced. By early 2000, wage negotiations, predictably, had stalled, and United's increasingly impatient pilots were getting stickers from the union reading, "On Top/On Time." They put them on flight bags, in the cockpit, everywhere.

As the deadline neared, Dubinsky reminded his pilots that they weren't obligated to fly overtime, as they normally did, and that they should fly "to the letter of our agreement" -- a euphemism for going slow. Late flights began to mount. Passengers went nuts. Goodwin was living a nightmare.

In May, he announced the merger, and the war with the pilots reignited. The nasty labor sore, bandaged but never healed, oozed with all the ugliness of the past. The pilots refused to fly overtime; some of them taxied at 3 knots instead of 15; others flew low, to burn more fuel, or opened landing gear prematurely, adding to wear and tear. Delays and cancellations soared; United, notably, suffered a fourfold increase in delays caused by pilots insisting on repairing inconsequential items, like a broken coffee maker or a burned-out reading light.

A pilot in California walked off a full 747, claiming nerves. An executive from a competing airline tells the story of a United flight from Los Angeles to J.F.K. when the captain announced that because of "low clouds" he wanted to recheck

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his instruments. They sat for three hours. The pilots were sabotaging their own company.

They did have reason to be upset. United, having grown more quickly than US Airways, had far more newer hires. Pilots feared for their careers and were infuriated that their counterparts at a weaker airline might supplant them -- especially since, they reckoned, management was paying for the deal with the very money it had saved on pilot wages.

Their anger was, of course, given a significant push from ALPA. Geoff Garrett, a United pilot from Seattle, says, "I never received an order to slow down." However, he admits, there was peer pressure. Pilots who flew overtime would see their names tacked to a bulletin board, and those who arrived on time got flack for "not flying safe." Mysteriously, an unsigned publication, *The Gardener*, began to turn up in cockpits, often in pilots' sun visors. The *Gardener* was a colored sheet written in country vernacular, reminding pilots to "fly safe" and so forth. Many pilots think it was produced by the Industrial Relations Committee, a secretive wing of ALPA formed by Dubinsky during the strike.

I asked Dubinsky about United's dismal summer -- 20,000 flights were canceled and on-time performance fell to 40 percent, disruptions that cost the airline \$700 million. He said: "The company was short on manpower; we told them that. And the weather was terrible. Also, our pilots decided to not fly overtime." Does that mean there was no coordinated effort? "That's what I'm telling you. If there had been, they could have taken us to federal court."

In fact, United's management had hotly debated whether to do that. Many were in favor, but Goodwin, who had the longest tenure and remembered the 1985 strike vividly, was unwilling to further antagonize the pilots.

And so in August, Goodwin agreed to an immediate pay raise of 22 to 28 percent and to additional 4.5 percent raises in each successive year through 2004. This pace-setting and lavish package stunned United's competitors, who had, of course, been guilty of no less in their turn.

Then the bottom dropped out. By 2001, high tech had gone bust, and big corporations like Hewlett-Packard, Cisco and Accenture were taking a hatchet to travel budgets. "We aren't talking about single-digit cuts," notes Jake Brace, United's chief financial officer. "Some of them reduced their flying by 25 to 50 percent."

These two grim developments were capped by a third misfortune when, last spring, the department of transportation blocked United's merger with US Airways. Thus, in the space of a year, United had suffered punishing blows from

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labor, the government and the economy -- a modest summary of the industry's troubles since deregulation. All that was before Sept. 11.

After the tragedy, Goodwin eliminated 20,000 jobs, but a cruel twist of businesses with high fixed capital, like aviation, is that cutbacks often worsen the problem. Though United saved 23 percent in expenses, it lost a whopping 39 percent in revenue. One reason is that union rules dictate that each pilot be able to bid for a better assignment (the bigger the plane, the higher the pay) whenever a vacancy opens. So while United furloughed 591 of its 10,500 pilots, it was also forced to retrain hundreds for new assignments, an enormous waste. "Now you have a ton of people being paid and not flying," notes Herb Hunter, an ALPA spokesman. "When they talk about laying off, you get to a point of diminishing returns."

This is why airlines cannot cut their way to solvency; needing cash to service debt on those \$100 million jets, they must keep selling assets, a downward spiral charted by the dearly departed Pan American. Realizing this, Goodwin warned that without concessions from labor, United could "perish." The unions demanded his head.

Over the years, major airlines have improved just enough for most to survive -- to limp from crisis to crisis, to turn a small profit occasionally -- but not to build lasting equity. And increasingly they are haunted by Southwest, haunted because they can never match it. Southwest is in a different business from United, and its model is infuriatingly simple: it flies a single aircraft type, greatly reducing the cost of training pilots and mechanics, with no frills or first class, mostly on point-to-point routes and usually from secondary, less congested airports. Its Boeing 737's land and take off in only 20 minutes -- unthinkable for planes connecting through hubs -- and its pilots usually fly more than 70 hours a month, far more than at American, Delta and United.

The traditional carriers, whose systems are built around hubs, can't do this. United's Chicago hub, for instance, draws customers from all over the Midwest, including people in smaller cities connecting to the coasts. Like the old phone company, this fulfills a vital need, but it is much more costly.

Jack W. Creighton Jr., United's new C.E.O., has become the latest chief to demand concessions from each employee group. He faces heavy sledding because United's mechanics, as well as its baggage personnel and ticket agents, are still working at pre-ownership-plan (1994) wages. They want a raise, like the pilots got, before they think about concessions. If the mechanics do not accept Creighton's offer and vote to strike, Congress, with the White House's authorization, could impose a settlement. And the White House has been signaling that it will tolerate fewer airline strikes in the future.

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So is government the answer to shareholders' prayers? Not exactly. Federal arbitration boards tend to resolve disputes by slicing down the middle, generally pleasing nobody. But they do force both sides to talk. And Creighton has held serious discussions with the AirLine Pilots Association. For now, they are talking only wage concessions -- not the work rule amendments that would be needed for United (and Delta, American, et al.) to join the rest of the 21st century. But the talks raise the germ of a possibility.

ALPA is demanding something in return for wage cuts. Since the value of the employees' stock from the ownership plan has crashed from \$5 billion to about \$750 million, they certainly won't take more of that. But Creighton and the union have talked about linking wage cuts, in some fashion, to United's profits or revenues. This brings to mind something Dubinsky -- at year-end, when he was retiring -- told me over vodkas in a restaurant near O'Hare. People say the pilots are self-destructive, he acknowledged, "but we aren't crazy." Meaning even pilots will ultimately do what is in their interest.

That is what's so interesting about Southwest, which has been able to co-opt its workers (who also are unionized) into behaving like owners. For sure, relationships with unions are multifaceted, but one difference at Southwest stands out, which is that workers get much of their annual profit sharing in cash. Maybe you can't eat stock, but you can eat cash. And if wages were to vary with performance, not only would United's labor costs stay tuned to the business cycle but its workers -- just maybe -- would also start to think differently about their employer. Over time, they, and potentially workers at other carriers as well, might be willing to fly more hours, to let the market determine the schedule for regional jets, to let airlines design their networks with profits as the main consideration. It sounds rather radical -- downright subversive in this industry -- but it is no more than what deregulation was supposed to accomplish almost 25 years ago.

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