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Airline Deregulation: Lessons for Telecom

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Airline deregulation created a whole new set of winners and losers. Those lessons learned could help telecom executives compete in their brave new world.

by Jonathan Byrnes

Top managers in telecommunications companies face a paradox. Many of their companies have huge market shares in one of the most promising, high-growth industries in our economy. Yet, as increasing deregulation enables competitors to encroach on their market share, revenues are threatened and all appears to be gloom and doom.

That's why these executives are asking how to reset their strategies to prosper in the industry's new era. The airline experience during the critical deregulatory period twenty years ago provides valuable lessons for these managers, as well as for managers in all industries facing major strategic change.

The seeds of long-term success or failure for the airlines were sown in the 1978-1983 deregulatory period. Deregulation pervasively changed the airline industry's underlying economic structure, necessitating a fundamental redirection of each airline's strategy. The key determinant of success or failure was whether a carrier reset its strategic paradigm—its underlying set of assumptions about the industry's economic structure and the basic competitive "win" strategies. Successful carriers comprehensively redirected their strategies to rest upon the industry's new bases for enduring advantage.

Over half of the major airlines made a similar, fatal strategic error in this crucial period. The failures of legendary carriers like Braniff, Continental, Eastern, Pan American, and Western all were avoidable. Their misstep? Each pursued strategies that were largely extensions of their "wish list" of old strategies that Civil Aeronautics Board regulation had long blocked. These carriers saw deregulation as an opportunity to finally accomplish their long-standing goals, rather than resetting their goals to protect their core businesses. While these strategies would have been successful in the regulated era, they were fatal in the changed industry.

The successful airlines had the clarity to systematically understand the new industry structure and the new bases for enduring advantage. In this era of great change, the companies that failed were not those with poor execution, but rather those that pursued inappropriate strategies.

The changing basis of enduring advantage

Under regulation, the key success factor for a small airline was to have a large proportion of high traffic point-to-point routes, like New York-Miami, with CAB-protected market share and profitability. The key success factor for larger carriers was to have a large number of long distance routes, like San Francisco-Hawaii, with high schedule frequency, dominant market share, and a distance-tapered fare structure.

Ironically, these routes were the most vulnerable to competitors in the deregulated environment. They provided the easiest entryways to new, low-cost entrants because they had a lot of traffic and did not require costly feeder systems. Established carriers could not successfully compete on price with non-unionized new entrants on these high-volume point-to-point routes.

The keys to success in the new industry structure were very different: (1) hub systems with schedule frequency that yielded cost and marketing economies, as well as secure cost-barriers to entry; (2) wide-service to provide a perceived service advantage, including frequent flier programs; and (3) powerful reservation systems to dominate the distribution channels. More focused strategies such as limited scope and regional concentration were also defensible. In addition, carriers needed strong balance sheets to withstand the predictable, potentially fatal fare wars that accompanied competitive entry into the industry's prime markets.

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Even for the successful carriers, change did not come overnight. They faced significant transition issues including: (1) making the unions more flexible to meet the new competitive environment, an issue with which many carriers are still struggling; (2) acquiring the needed equipment and gate space; and most importantly, (3) overcoming longstanding management attitudes appropriate for the regulated area, including, critically, the emphasis on short-term growth rather than long-term profitability.

Old strategies in a new industry
Braniff, Western, Continental, Eastern, and Pan American all failed because they did not reset their strategies to secure their core businesses.

- **Braniff**. Braniff added a large number of low schedule-frequency, high-density, point-to-point routes. Under regulation the CAB would have provided a protected market share on these routes. But without CAB protection, and without a secure feeder system, Braniff's routes were attacked, quickly forcing Braniff into bankruptcy.

- **Western** and **Continental**. Both carriers entered deregulation with a large proportion of lucrative, high-density, point-to-point routes. As deregulation made new routes available, both increased their exposed routes and dropped the smaller cities with feeder potential. Their lack of a hub system and high exposure made them vulnerable to aggressive competitors. Ultimately both carriers' incumbent management teams were forced out and both carriers were taken over.

- **Eastern**. Eastern spread its system thin by sprinting towards national scope. It added numerous, diverse long-distance routes with one or two flights per day, rather than focusing on building secure, dense hubs to gain system strength. When new entrants waged fare wars on these unprotected routes, Eastern's balance sheet was too weak to sustain the carrier.

- **Pan American**. Pan Am needed a gateway feeder system to leverage its substantial international routes. But whereas Pan Am's international routes were predominantly East-West, it acquired National, a carrier with a small number of routes, largely exposed high-density North-South ones. This was the root source of Pan Am's spectacular bankruptcy.

These carriers did not fail because they made managerial errors—all carriers made errors. Rather, these airlines failed because they pursued old strategies; they failed because they did not reset their strategies to meet the realities of the changed environment.

The successes
The successful carriers in the post-deregulation period recognized the need for change, understood the new bases of enduring advantage, and systematically reset their strategies to secure their base cash flow.

- **American**. American pursued a hubbing strategy that drew leverage from the new industry structure, built a strong scheduling reservation system to dominate the distribution channel, negotiated an innovative union contract, and reduced its diversification to focus on its airline business and to free the resources to be a strong competitor. American led the airline industry for years.

- **United Airlines**. Originally United pursued a strategy that would have been ideal under regulation: It increased its long-haul routes and dropped many of its feeder routes. Heavy competition on its exposed long-haul routes resulted in poor performance for several years. Due to its financial strength, however, United was able to correct its strategy mid-course by developing a multiple-hub strategy, strengthening its reservation system, and enhancing its frequent-flier programs.

- **Delta** and **Northwest**. Both airlines emerged from their regulated years in very strong positions, with conservative capital structures, low operating costs, and strong regional hub systems. Both built on these strengths steadily in the post-deregulation period, achieving defensible competitive strategies with a greater degree of geographic focus and lower cost profile than American and United. Both remained successful while they pursued this careful, systematic strategy.

- **Trans World**. This carrier was an anomaly. The parent corporation was highly diversified and the airline was weak. Trans World Corporation "succeeded" by spinning off the airline and continuing its lucrative diversification.

Lessons for telecommunications
Today the telephone industry is undergoing basic structural change as pervasive as the change that swept the airline industry twenty years ago.

The airline experience demonstrates that resetting a company's strategic direction to secure its core business in an era of structural change is both very difficult and critically important. This is particularly problematic in the telephone industry because there is no clearly demarcated event, such as the Airline Deregulation Act of 1978, around which to galvanize action.

The telecommunications industry is changing steadily and rapidly, but in a subtle and diffuse manner. The serial nature of the change increases the demands on executives to combat recurring brushfires, making it difficult to remain focused on the forest rather than the trees.

Today, the major telecommunications companies, the telco and cable firms, are converging on a similar strategy of providing broad-market coverage, offering a wide breadth of products, and bundling the products into unified multi-product rate structures. All the while, the telcos are trying to reduce their historically-high costs. The industry participants are skirmishing over initiatives to increase VOIP (voice over internet protocol) and broadband programming.

This generic strategy has elements needed for success in the newly-forming telecommunications industry, along with elements appropriate only for the old. This is not enough.

Each telecom company previously lacked one or more important products needed to achieve the once-elusive goal of a “full-service network.” Now, with regulatory change, they are focused on achieving their longstanding vision.

The problem, however, is that for strategic success in the new industry, telecom executives must move rapidly beyond their old goal of comprehensive offerings to a new goal of customer/product selectivity, including importantly, identifying and binding together natural “communities of interest” in the market. And, in critical ways, selectivity is the opposite of their traditional objective of comprehensiveness. In a striking parallel, the key to success for the deregulating airlines was to select defensible hub-based route systems, and the big mistake was to simply fulfill their age-old wish for a comprehensive route system.

The principles of profitability management, the subject of this column, provide an effective basis for resetting telecom company strategy. Faced with the inevitable steady erosion of market share, telecom managers confront a stark choice: either they can choose which customers to lose, or *competitors* will make that choice by picking off the best customers. Not losing customers is simply not an option.

If telecom managers give in to their instinct to try to hold onto all business, their competitors will take away the most profitable, high-growth segments. If, on the other hand, telecom managers use profit mapping (see "The Hunt for Profits" to analyze the market, they can segment the customer base into the parts that can be grown rapidly and profitably, those that can be improved to be made profitable, and those that are inherently marginal at best in growth and profits.

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With this knowledge, telecom managers can focus their efforts on coordinating and packaging their diverse services to secure the high-growth segments and to turn around select marginal ones, while ceding to competitors the inherently unprofitable segments (which competitors with different cost structures might well serve profitably).

Telecom managers today have a historical opportunity to develop new bases for enduring competitive advantage, which will yield both immediate and long-term revenue and profit growth. Critical first-mover advantages will accrue to those who act decisively to align their market targeting and service delivery systems before the best business is taken by more focused competitors.

Today, the telecom industry is hauntingly similar to the airline industry of twenty years ago. Telecom managers can have any part of the market they choose, but not everything. If they fail to choose, and try to hold onto it all, they will lose the best parts. Like airline managers of twenty years ago, the choice is theirs.

See you next month.

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