

Airline Alliances: Why They Form, How They Work

The AirLearn Series in Airline Fundamentals

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Today's Agenda

- A paradox: regulatory constraints in a global economy
- The forces that drive alliance formation
- Customer benefits
- Types of cooperation
- Summary of American Airlines' alliances
- Critical success factors
- Questions and discussion

> This presentation will be available as a PDF file

Giving Thanks

- For more than 20 years, American Airlines has supported my teaching through travel and other support
- Without their help, this year I would not be able to visit more than 25 schools on four continents
- American Airlines has for decades believed strongly in supporting the communities it serves
- It is proud to be a good corporate citizen – in Canada and all over the world
- You can learn more at **AA.com/joinus**

Some “*Facts of Life*” about Airlines

- The two types of carriers – old ones and new ones – have very different operating costs, mainly driven by labor
 - An unhappy result of decades of government economic regulation
- Profit margins are thin – or nonexistent
- High fixed costs (70-80% of total) drive decisions
- It's hard to match supply and demand
 - Demand varies temporally, by time of day, day of week, and season
 - Product is perishable
 - When demand declines, airlines cannot remove costs quickly enough, or proportional to the decrease
 - Low barriers to entry, and high barriers to exit

Some “Facts of Life”

- Airlines are capital-intensive, labor-intensive, and energy-intensive
- The airline market is competitive, but the markets that supply the business are not
 - Unionized labor and airports are monopolies
 - Aircraft and engine makers, and others are oligopolies
- Government influence has been and remains enormous
 - The legacy of domestic regulation – to be discussed in a moment
 - Infrastructure on the ground and in the air
 - Excessive taxation
 - Outmoded controls on foreign ownership
 - Continued regulation of international flying

A Catalyst to Economic Development

- Airline services precede or facilitate the flow of investment, information, and human capital – what we commonly call “business travel”
- Enable global logistics, the fast movement of high-value, perishable, or time-sensitive goods
- Provide the indispensable foundation for tourism, by many measures the world’s largest single industry
 - About 40% of international tourists travel by air

A Network Business

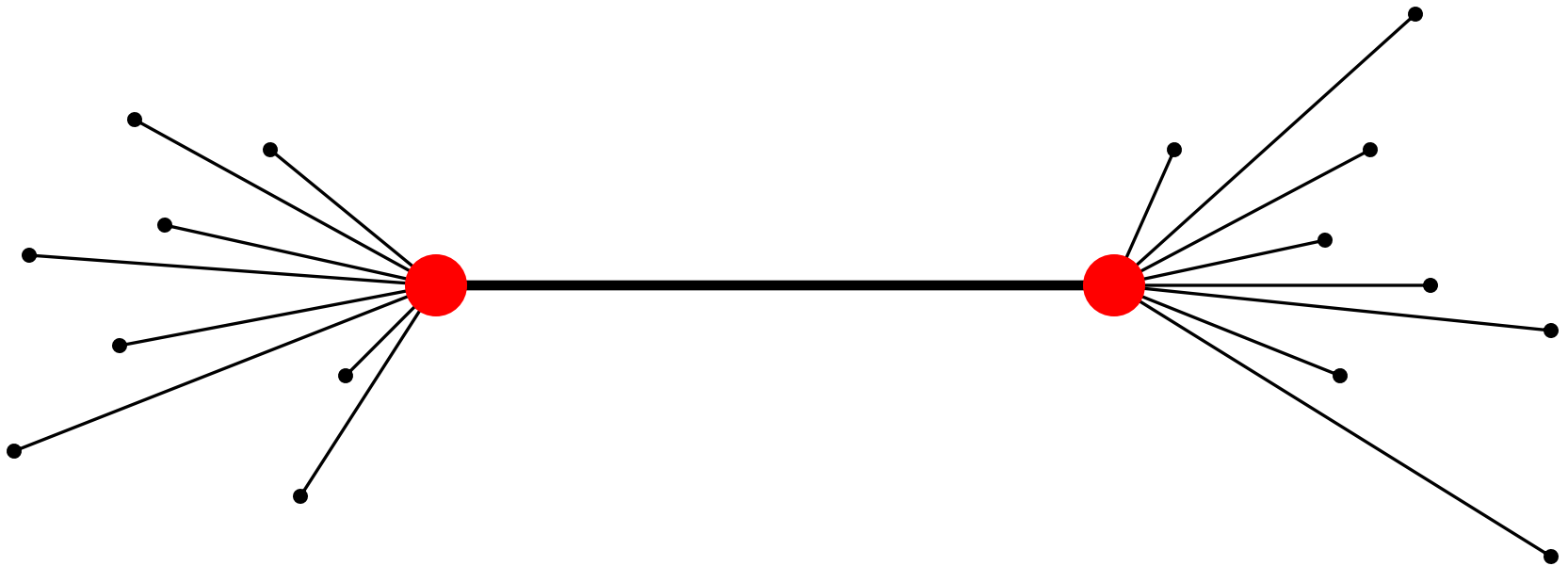
- Like other kinds of businesses, for example telecoms, airlines benefit from network breadth
 - The mobile phone analogy works well!
- The basic product is the ability to carry a customer from origin to destination
- Thus the more of these “O&Ds” airlines can offer, the better they will do . . .

A Network Business

- International carriers compete for four types of traffic
 - Gateway to gateway: Toronto-Frankfurt
 - Gateway to beyond a gateway: Toronto-Kiev, via Frankfurt
 - Behind a gateway to a gateway: Winnipeg-Frankfurt, via Toronto
 - Behind a gateway to beyond a gateway: Winnipeg-Kiev, via Toronto and Frankfurt

The Ideal Network, Simplified

- In simplest schematic terms, the ideal network looks like this:



Domestic Deregulation

- As noted earlier, for 50 years, the U.S., Canadian, European, and other governments tightly regulated three key economic parameters: business entry, routes, and prices
- The U.S. Congress deregulated U.S. domestic airlines in 1978; similar action followed in Canada in the 1980s, and the EU in the early 1990s
- This legacy created the two-tier structure – and many of the financial troubles – that we discussed earlier

Continued International Regulation

- International flights were unaffected by domestic deregulation
- The international regulatory framework dates to the Chicago Convention of 1944
 - Participating nations rejected the U.S. proposal for an open, multilateral regime
- Instead, what emerged was a complex web of country-to-country, or bilateral, agreements, completely separate from other world trade rules
- The basic rule: everything is banned, unless expressly permitted

What Drives Alliance Formation?

- As just noted, international airlines are subject to a complex and invasive array of government regulation; two are most relevant here:
 - Controls on foreign investment
 - Irrelevant today, these are a vestige of security concerns in the mid-20th century
 - Provisions of bilateral agreements may prevent us from operating our own aircraft, but permit codesharing or other types of alliance cooperation
- Thus airlines are imbued with a national identity nonexistent in other sectors

What Drives Alliance Formation?

- As we have seen, airlines benefit from economies of scope
 - bigger networks are better
- “Virtual networks” can be built with little capital and much less risk compared to operating your own aircraft
 - American Airlines’ 1970s and 1990s experiences in the Australian market are perfect examples

What Drives Alliance Formation?

- Global distribution systems like Amadeus and SABRE
 - The “electronic shelf” where much travel is sold
 - Display parameters favor same-airline connections:

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- Perceived attractiveness of codeshare connections

What Drives Alliance Formation?

- Global alliances are also a competitive, defensive response:
 - Competition for high-value passengers has intensified in recent years
- Opportunities to sell services and expertise to other airlines
 - For example, American Airlines provides ground-handling services to Iberia at New York and Chicago

What Are the Customer Benefits?

- The most loyal and profitable international customers demand a global network that offers
 - Linked frequent flyer programs, sometimes called loyalty programs: the ability to earn and redeem miles across programs, and be recognized
 - Synchronized schedules
 - Easier airport connections
 - Access to private lounges before and between flights

How Do Carriers Cooperate?

- Alliance cooperation principally involves two activities
 - Reciprocally linked frequent flyer programs
 - Codesharing, generally (but not always) reciprocal
- In recent years, joint ventures have become common
 - KLM and Northwest pioneered these nearly 20 years ago
- Alliances may also include
 - Airport co-location
 - Joint procurement and purchasing
 - Technical exchange
- But it's mainly about revenue

What Are the Types of Alliances?

- Multilateral global programs, like Star Alliance, SkyTeam, and **oneworld**
- Bilateral alliances
 - These are the foundation of the three multilaterals
- Programs with immunity from competition laws in the U.S. and EU – these are the deepest alliances
 - Star, for example, has many immunized relationships
 - Delta-Air France-KLM is projecting 50,000 seats per day and \$12 billion in annual revenue
 - American-BA-Iberia, finally given U.S. and European approval
- Low-cost carriers have also begun to ally, with other LCCs and with network airlines

Antitrust Immunity in Global Alliances



* Announced new alliance members

American's Codesharing and FFP Alliances

- Across the Pacific
 - **oneworld** Partners
 - Cathay Pacific
 - Qantas (including Jetstar)
 - Japan Airlines (joint venture relationship)
 - China Eastern
 - EVA Air



American's Codesharing and FFP Alliances

- Across the Atlantic
 - **oneworld** Partners
 - British Airways / Iberia (JV)
 - Finnair
 - Royal Jordanian
 - Malév (Hungary)
 - S7 of Russia
 - Kingfisher (to be implemented)
 - Jet Airways
 - El Al (on AA flights, not vice-versa)
 - Gulf Air
 - Etihad
 - Air Berlin
 - Deutsche Bahn (railway)



American's Codesharing and FFP Alliances

- In the Americas
 - **oneworld** Partners
 - LAN (including affiliates)
 - Gol, a fast-growing low-cost carrier in Brazil
 - WestJet, Canada's low-cost leader
 - Alaska Airlines
 - Hawaiian



What Are the Critical Success Factors?

- Alliances are rewarding, but present eight key management challenges
 - Aligned expectations
 - Win-win financial provisions
 - Pricing and settlement
 - Cultural compatibility: corporate and national
 - Consistent quality and other customer-service issues
 - Network fit
 - Well-coordinated I.T. systems
 - Smooth airport interfaces
 - Coordinated selling and distribution

Time for Your Questions!

