Airline alliances: consumer and policy issues

Airline alliances have become a polemical issue in air transport – important, on one hand, for the airlines as means to circumvent peculiarities in international air transport regulation, but on the other hand, raising difficult questions for policy-makers in regard to consumer and competition issues. Although the alliance has become a strategic necessity, it suffers from an inherent instability in sustaining a common ground for two or more independent airlines as well as gradual reduction in alliance benefits due to competition-enhancing law and regulation.

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An alliance is, among other things, an alternative to a total unity between two international airlines with strong national identity, which makes it politically and legally difficult for them to merge. The airlines became their countries' emblem of independence often under full or partial nation ownership. Civil airlines rose from the ashes of two World Wars, which had a great impact on how international air transport regulation developed. Unlike shipping, where the 'freedom of the seas' is a governing principle, air transport was restricted by its military threat demonstrated in World War I, leading to the principle of a country's 'complete and exclusive sovereignty over the air space above its territory' (Lowenfeld, 1981). Although an attempt was made to create 'freedom of the air', such attempts failed understandably in the war era leading to a system of bilateral agreements where countries go through painstaking negotiations with each other. Bilaterals cover usually the Third and the Fourth Freedoms (Table 1) that were supposed to become generally accepted 'freedoms' of the air following the Chicago Convention in 1944, but became instead elements of negotiation. The Fifth, Seventh and Eight Freedoms, the last being the so-called cabotage, are generally not available through bilaterals, making globalisation of airline companies cumbersome and virtually impossible in terms of access to large markets such as the United States. Legislation often limits foreign ownership of airlines to a minority holding for security reasons. This article concentrates on the potentially dissipating benefits from airline alliances in a number of areas, with reference to the EU–US air transport markets.

Will the intra-EU alliance perpetuate?

Alliances create an obvious benefit for international airlines as they facilitate an extension of an airline's network into a domestic territory that is closed to foreign carriers. This applies, for example, to Europe and the US, but does not answer why alliances became so popular within Europe in the 1980s prior to the proliferation of international alliances. As the liberalisation process took off

TABLE 1: Freedoms of the air

First Freedom	To fly over another state
Second Freedom	To land in another state in emergency or for refuelling
Third Freedom	To put down revenue passengers and freight from state of registry
Fourth Freedom	To take on revenue passengers and freight to state of registry
Fifth Freedom	To take on revenue passengers and freight in a second state to a third state
Sixth Freedom	To take on revenue passengers and freight in a second state and fly via state of registry to a third state
Seventh Freedom	To take on revenue passengers and freight in a second state, in which the aircraft can be domiciled, to a destination in a third state
Eighth Freedom	To take on revenue passengers and freight in a second state to a destination within that state

in Europe, EU airlines had been watching deregulation in the US closely, observing the impact of low fare carriers and the resulting shift to cost reduction. However, costs are the fundamental weakness of European flag carriers who usually face strong resistance by unions when it comes to cost cutting. As a result, European flags had to secure a time for adjustment and develop strategies to secure their future at both the operational and governmental levels. In retrospect, one must conclude that such strategies have been highly effective at both levels and have delayed an eventual shake-up in European air transport.

One of the delaying factors, in addition to capital injections to ailing carriers, has been the intra-EU airline alliance. Such alliances have not been created in the US domestic market among large US carriers to the same extent. In fact, there was little incentive to do so because a merger is a better and more stable long-term option. Approximately 30 large airline mergers have been approved in the US since deregulation in 1978. However, this is changing as several large US carriers have announced 'marketing agreements' among themselves. The balance was tipped by Northwest and Continental announcing in January 1998 their 'strategic global alliance'. This was followed by announcements in April 1998 by American Airlines and US Airways on the one hand, and Delta and United on the other. According to US regulations, code-sharing, mergers and alliances must be referred to the US Government, and it may investigate the possible anti-competitive impact or violation of anti-trust laws. However, the airlines forming the domestic alliances claim that cooperation will not take place on issues that would need governmental referral, such as joint price setting and route planning. Continental joining the Northwest–KLM alliance will require governmental referral due to the anti-trust immunity secured by that alliance (the first alliance to receive such immunity). Here again the potential instability of an alliance, let's say the potential promiscuity of partners, is made clear as a fourth major player enters an established alliance creating complications in regard to management and product compatibility. In fact, managers of the STAR Alliance of six partner airlines (Lufthansa, United Airlines, Air Canada, SAS, Thai Airways and Varig) are already complaining about the 'logistics nightmare' of coordinating the airlines and early management conflicts were also experienced in the world's closest alliance, KLM–Northwest. There is no doubt that domestic alliances will be heavily scrutinised by the US Congress, raising the issue of domestic alliances to new heights, with obvious implications for EU domestic alliances. Given that the former disfavours major domestic alliances, it is only to be expected that the European Commission will take a similar stand to facilitate an Eight Freedom environment between the two continents that will inevitably come up if the Commission secures the ability to negotiate multilaterals on behalf of all member states.

The ultimate purpose of deregulation and liberalisation was to generate consumer benefit through lower cost air travel achieved by more competition and downward pressure on costs through greater efficiency. All of that was achieved to a greater or lesser extent in the US, making the US carriers formidable competitors for the Europeans who still gain from limited success of EU low cost new-entrants, protective bilaterals, the protective stand of some national governments and slow progress in putting consumer issues in the driving seat. Here again, the intra-EU alliance plays a part in keeping the peace by effectively dividing markets, colluding in rate setting and controlling capacity – reinforced even further by airport congestion in main markets. Alliances among EU carriers have been granted exemption from Article 85(3) of the Treaty of Rome, creating geographical fortresses that are difficult to challenge, providing one explanation why so many independent carriers have been integrated into the flags through acquisition. In addition, access barriers such as airport charges and ground handling at the national and local level are still substantial, reducing the full benefits of liberalisation.

With the persistent, though slowly declining cost differential between US and European airlines, the European airlines still need time to adjust cost structures to face the Americans in an Eight Freedom environment. However, an adjustment through relaxation of the national ownership laws would be a step on the way whereby US as well as EU carriers could opt for full ownership of existing carriers in each other's territories or start their own independent companies from scratch using a domestic labour force. This would maintain stability in labour markets on both sides of the Atlantic and allow European consumers ample benefit from liberalisation in Europe in terms of lower prices and better connections, especially in secondary markets.

Alliance benefits are cardinal to airlines

An alliance has to have an ingredient that the two sides cannot achieve unless they work together. In high-tech industries this would be a process or patent held by either party. The most important benefits of an alliance are:

1. Code-sharing, which improves computer reservation systems' priority listing and allows the virtual extension of a foreign carrier into a domestic market it cannot serve.
2. The amalgamation of frequent flyer mileage awards across the whole network of the alliance partners.
3. Traffic feed into international gateway hubs of partners.
4. Schedule coordination as a means to increase the perceived seamlessness of the code-shared service, reducing passenger waiting times at hubs and the likelihood of competitors having more convenient connections.
5. Resource sharing through the reduction or elimination of duplication of sales offices and staff at major airports, as well as joint marketing and sales programmes.
6. Access to congested airports, by exchange of slots and terminal facilities.
7. Technical cooperation on the operational front such as maintenance, access to flight equipment in emergency and integration of information systems.
8. Access to an established system of travel agents' commission overrides.
9. The halo effect that stems from the tendency of travel agents to book a well known domestic brand, an obvious gain for a foreign airline.

Just as the alliance between two or more airlines is unstable, the benefits on which basis the alliance is formed are also insecure. Research into 34 large airlines having 10 or more alliance partners in 1998 revealed that in the period 1994 to 1998 these airlines had had 491 alliance partners in total, of which 28% or 138 had been dropped in the period. The total number of alliances was 502 in 1998, up from 280 in 1994, an increase of almost 80% in five years. This phenomenal growth in the number of alliances raises the stakes for airlines, consumers and the policy-maker.

Table 2 shows some of the main benefits that alliance partners extract from an alliance and whether the benefit is likely to be stable or not.

Should benefits from code-sharing be limited?

When computer reservation systems (CRS) were first introduced, they were a simple extension of large airlines' in-house systems, enabling the system's host to exploit a unique position through display and architectural bias, and the halo effect, creating incremental revenue (see Table 3). As experience accumulated in the US deregulated market, the emphasis shifted from competition-limiting regulation to competition-enhancing regulation. One element of this latter move was to reduce the biases of the CRS by regulations governing the priority of flight listings on the CRS display. It has been estimated that 80 to 90% of

TABLE 2: Stability of airline alliance benefits

Alliance element	Present benefit from alliance	Possible future status of the benefit
Code-sharing	Multiple listing of a single flight causing crowding out effect on CRS display	Restriction on multiple listings of flights (one flight, one listing)
Joint frequent flyer programmes	More benefit alternatives (holiday destinations, etc.) and larger network to accumulate frequent flyer miles	Competitors allowed to join frequent flyer programme as a concession of allowing the alliance
Cross-border feeding	Seamless service through an international hub to a large set of domestic destinations	Multilateral 'open skies' agreement allowing cabotage
Schedule coordination	Reduction of hub waiting times to reduce incentive to use more convenient competitors' flights	Stable benefit
Resource sharing	Elimination of staff duplication at airports, joint marketing and use of sales offices	Stable benefit
Airport access (slots)	Access to congested international gateways through sharing and exchange of slots and terminal facilities	Benefit to rise rather than decline due to increasing airport congestion
Technical cooperation	Technical cooperation such as maintenance, emergency equipment and information systems	Stable benefit
Travel agent commission overrides	Foreign carrier enters travel agents' commission override scheme of partner, increasing travel agent's incentive to book the foreign carrier on international flights	Travel agents required to disclose to customers that they receive an override on a booking
Halo effect	Travel agents' tendency to book more on a carrier associated with a brand they know	Stable benefit

flights are booked from the first screen of the CRS display even though a lower priced or more convenient flight might exist on the second or third screen. As a result, the airline owners (hosts) of CRS in the US had, prior to the regulation, listed their own flights with priority over competitors' flights on their display. After the regulation and from the outset in the EU-based systems (Amadeus, Galileo), display priority was established as follows: first, direct flights; second, indirect flights on same airline, referred to as 'online'; and third, indirect flights on two or more airlines, referred to as 'interlining'.

In the US the CRS display rules had a serious impact on the so-called feeder carriers that usually had interlining agreements. Such flights, after the passing of the 1984 regulation, were suddenly moved from the first screen on the CRS display to the last. The survival of these feeder carriers and the seamless operation of hub and spoke networks depended on thinking up a strategy to improve the display priority, leading to extensive use of code-sharing, where a flight on two carriers is listed under one code. It appears as a flight on the same carrier (online) although two carriers are involved.

Another advantage emerged, namely the multiple listing of a single flight, creating a crowding out effect on the CRS display that improves the chances of the flight being booked by the travel agent. One example is a United Airlines (UA)–Lufthansa (LH) code-shared flight from Berlin, through Frankfurt to Chicago operated by LH from Berlin to Frankfurt and by UA onwards to Chicago. First the flight is listed under the codes of Lufthansa from Berlin to Frankfurt, and from Frankfurt to Chicago. Then the same two flight segments are listed under the codes of

TABLE 3: Glossary of terms

Architectural bias	Built-in system features that make it easier or more beneficial for the agent or customer to use the system owner.
Bilateral	Air transport agreement negotiated between two sovereign states. Usually (Bermuda type) naming one Chosen Instrument (flag carrier), specifying rate-setting procedures, gateway airports, capacity division and technical aspects necessary for international air transport. Open Skies (US 1992) bilaterals are less restrictive, opening up freedom in capacity offered, rate setting, gateways chosen and so forth.
Chicago Conference 1944	Held to reach agreement on: (i) setting and enforcing standards for safety and, communication and sharing of technology advancement (successful); (ii) economic regulation of international air transport (unsuccessful).
Code-share	Code-sharing involves one airline placing own code on the flight of an other airline.
Computer reservation system	A system matching supply and demand for travel services over an information network.
Halo effect	Tendency to book the services provided by the system owner because of greater name recognition and perceived trust.
Incremental revenue	The revenue earned by the system owner due to halo effect and architectural bias.
Multilateral	Granting a unified set of freedoms accepted by signatory states. The US wanted such agreement at the Chicago Conference named the Five Freedoms Agreement (see Table 1). The Commission has sought authority to negotiate a multilateral agreement with other states such as the US.
TACOS	Travel agent commission override involves paying higher commission if the agent reaches a certain level of bookings. Overrides vary from one carrier to another and from one market to another.
Yield management	A system used for capacity control and rate determination to maximise revenue.

United Airlines. Then each of the two flights is listed separately as actual flights for interlining (both airlines' codes appear in the ticket), resulting in three sets of listings for the same flight. This leads to the possibility of a crowding out effect where competitors' flights can drop down to the second screen. This enhanced market presence through code-sharing is clearly a strategic advantage derived from the alliance and has a potentially negative impact on consumer interest. Thus, multiple flight listings are a possible area for competition-enhancing regulation, although the US Department of Trade has rejected a ruling on the issue so far. However, the European Commission has a tougher stand that limits code-shared flights to two listings in a CRS, while aviation experts taking a pro-consumer stand talk about a single listing as being in consumers' best interests.

Opening-up of frequent flyer programmes to competitors

Alliances are important when it comes to frequent flyer programmes (FFP) because such programmes are likely to include a provision for accumulation of miles in the joint network and a larger set of exotic holiday destinations to members. The FFP is an important competition tool, especially in the business market, as it works as a rebate for business passengers flying on behalf of a company but receiving the benefits personally. As a result, the airlines can maintain the loyalty of the business passenger by increasing the miles earned in the face of lower priced competition. Another aspect of integrating FFP is that such decisions receive less scrutiny by authorities than international code-sharing agreements, as has been demonstrated by the British Airways-American Airlines cooperation in this area. There are even voices saying that the benefits derived from FFP are greater than those of code-sharing and remain stable while code-sharing is more vulnerable. Some not so transparent benefits from merged FFP are data-mining allowing more focused marketing, sales and product development. However, the FFP has been subject to competition enhancement measures such as requiring alliance partners to allow a competing carrier to participate in their FFP.

Cross-border feeding

Cross-border feeding allows a foreign carrier access to an enlarged market through international hubs, which is by nature reciprocal for both partners. Thus the emphasis of competition intensity in foreign markets switches from carrier-to-carrier competition to network-to-network competition, with obvious economies of scope and density benefits for network partners. Recently the pressure to arrive at some solution to the EU–US bilateral issue has increasingly put the Eight Freedoms into the limelight as part of a multilateral agreement negotiated by the European Commission rather than by each member state. If such agreement is reached, one of the main benefits of an airline alliance will be reduced, as a foreign airline could effectively establish its own extensions. However, it is more likely that pressure to relax the ownership regulation will become crucial so that alliances can be turned into full-scale mergers. Better still, a phased-in approach to increased freedom in international air transport would probably involve first the relaxation of airline ownership rules and then progress towards an Eight Freedom multilateral.

Airport access

Airport congestion increases rapidly each year. Entering congested airports can cause problems such as departure slots being scheduled too close together, slots being awarded at inconsistent times, at less favourable times than competitors and finally not awarded at all. An alliance can contribute to improved management of slots for the alliance partners and provide for access to additional airport slots. On the other hand, the European Commission usually requires airlines contemplating a merger or alliance to give up slots to competitors as a way of lessening the anti-competitive impact of the new entity. The proposed British Airways–American Airlines–Iberia alliance would have controlled 61% of the passenger market-share out of Heathrow and a total of 28% of the EU passenger traffic. The main competing alliance formation, the 'Star Alliance', would have had only 18% market-share out of Heathrow and 17% overall European share. In this situation it is perhaps no wonder that the European Commission has investigated to what extent slot concessions should be required. The competitors of the BA/AA alliance have stated that they need a minimum of 800 extra weekly peak slots to mount effective competition, while the UK Office of Fair Trading called initially (1996) for 168 US–UK slots to be given up to competitors. In 1997 the total number of slots allocated by both carriers to the US–UK market was about 500 weekly slots in total, while BA holds approximately 3000 weekly slots out of Heathrow. US carriers can trade their slots as assets, while such practice is not built into the slot allocation system in Europe. The BA/AA alliance has said that if it were to give up a large number of slots out of Heathrow the concession should be valued and compensation provided. This is effectively a proposal for a fundamental change in the slot allocation apparatus and therefore a separate debate. The European Commission has shown that, if we keep the US–UK 'Open Skies' bilateral issue aside, the anti-competitive impact of airline alliances can be challenged through slot concession requirements to such an extent that the benefits seem marginal at the outset.

The role of travel agents in alliances is often underestimated

Travel agents' commission override schemes (TACOS) are important marketing tools to create loyalty to a specific airline among independent travel agents. Although travel agents strive to maintain their independence as consumer advisers, they receive extra commission usually based on reaching certain sales levels on a specific airline. As the travel agents operate on tight margins these overrides are important and therefore likely to shift sales towards an airline that is most likely to maximise their income from overrides. A foreign carrier trying to distribute its product in the US, for instance, has less of a chance to come in at the strong end as US travel agents are more likely to favour a carrier with strong domestic presence. However, an alliance between a European and a US carrier is going to provide for an equal playing field as the alliance carriers will benefit from each other's TACOS. Here again, competition-enhancing regulation seems to be stepping in. Voices in the US suggest that travel agents should be required to disclose to the customer any override they are receiving.

Concluding remarks

Alliances in the form that we now know them are transitory phenomena based on the constraints of international law and regulation. Some of the most important benefits to the airlines are derived from biases and collusion that are allowed only by exemption on behalf of the European Commission and the US Government. If the political climate remains focused on consumer protection, competition-enhancing regulation is bound to reduce alliance benefits. Furthermore, the move towards free trade and globalisation is bound to step up the pressure to change the bilateral regime in international aviation. A possible first step in that direction is an Open-Skies Multilateral Agreement between the US and the European Community, allowing Eight Freedom traffic and ownership of airlines by foreign interests, and creating a truly single market in air transport between two large continents. There is no doubt that airline alliances have improved service in many respects but at the same time raised some difficult questions for the policy-maker. It is likely that we will see in the next five to ten years major changes in international air transport leading to the decline of the airline alliance but the rise of the multinational global carrier, firmly constrained by competition-enhancing regulation.

Reference

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