GAINING A COMPETITIVE EDGE THROUGH AIRLINE ALLIANCES

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Abstract

Alliances and code sharing have become increasingly popular among airlines of all sizes as costs associated with expansion become impractical. To remain cost efficient and compete effectively in various markets, most airlines have formed alliances with other airlines to further strengthen their economic potential. Economic benefits of alliances and code sharing are examined. Either arrangement gives the airline a competitive advantage over those that do not enter into these agreements.

Introduction

The post-deregulation–era airline industry has seen many U.S. and foreign carriers moving into new phases of economic agreements in order to gain competitive advantages in their various markets. Alliances and code sharing have emerged as the most common business models used by airlines today. Both methods are economic agreements and have proven to be very effective by permitting airlines to effectively add routes to their systems virtually overnight, instantly enlarging their market share. While other models exist, such as the one used by Southwest Airlines that has point-to-point routes with no hubs, this article will only address strategic alliances and code sharing.

Alliances

An alliance, as defined by the Federal Aviation Administration (FAA), is "a merging of resources, operations, or financial interests between [one] entity and [another] entity. This entity could be an air carrier or a repair station and could involve the sharing of parts or the utilization of mechanics, pilots, and flight attendants" (FAA, 1995). Between 1993 and 1996, alliances were the fastest growing area of competitive advantage for airlines (IATA, 1996).

Alliances can include code-sharing agreements, marketing arrangements, procurement policies, system commonality, and interchanges of flight-crew personnel and aircraft. Other less complex alliances may consist of only frequent flier mileage agreements and a few other amenities such as passenger through check-in. For example, Continental airlines currently has a global alliance network with 17 different airlines that vary in complexity (Continental Airlines, 1998a).

Alliances can be broken down into three categories; strategic, regional, and point-specific. Strategic alliances involve code sharing and other agreements on a vast number of routes such that both airlines' flight networks are strategically linked. Regional alliances typically involve similar agreements between two airlines on several routes within a specific region. Point-specific alliances refer to agreements between airlines involving flights between a small number of cities. They often involve one airline purchasing blocks of seats on another airline's flights, then reselling them.

When there is a merger or acquisition, one of the airlines, usually the smaller, will cease to exist upon completion of the proceedings, and a new corporation will emerge. An airline alliance should not be confused with a merger and acquisition since these actions involve the combining of two airline companies into one large organization. An alliance is a much more limited combination of resources, and the airlines involved keep their identities.

Code Sharing

The FAA defines the term "code-sharing" as "[A] marketing arrangement that permits... a carrier to sell service under its name and airline designator code when the service is provided in whole or part by another air carrier" (FAA, 1995). Code sharing is simply a "marketing arrangement" aimed at benefiting both participants economically without the complexity of an alliance. Code-sharing agreements require only the approval of the Department of Transportation, which publishes a monthly listing of all current code-sharing arrangements.

A somewhat similar concept is called interlining. When airlines practice interlining, the airlines establish joint fares and coordinated flight schedules, but each "retains its own identity, and flight segments are clearly labeled as to which carrier is providing the service" (O'Connor, 1995). Code sharing differs by having a single ticket issued which may reflect a single carrier through to the final destination; however, the actual passage may involve two or more different airlines.

Some agreements can fall into a gray area as to whether they are alliances or actual mergers, such as the Northwest-Continental deal currently before the Department of Justice (DOJ) for review. The plan has been sent to the DOJ and is being treated as a legal merger, since Northwest is buying a 14% stake in Continental, which carries with it 51% of the voting rights of that airline. However, the two companies do not plan to integrate and will keep managements, planes, and personnel separate while employing full code-sharing and meshing of their schedules and computer reservation systems in what is being called a "virtual merger" (Carey & Ingersoll, 1998). This terminology may eventually become the standard description of all such agreements.

Advantages of Alliances and Code Sharing

Airlines mainly enter into alliances and code-share agreements in order to expand market share and gain entry to otherwise difficult to enter market segments, or to eliminate competition from some of its routes (O'Connor, 1995). Alliances and code sharing are ways for an airline to expand its network without heavy investments (Carey & Ingersoll, 1998). U.S. airlines enter into strategic alliances with foreign carriers primarily because it is uneconomical for them to serve some foreign cities with their own aircraft. Also, some government bilateral agreements limit their ability to directly serve many foreign markets, making alliances even more attractive (USGAO, 1995). Foreign airlines are calling for governments to ease restrictions on foreign ownership regulations that create barriers that prevent foreign carriers from operating within U.S. boundaries. In effect, foreign airlines would like to see cabotage, allowing foreign carriers to fly domestic routes, permitted within the United States. Such a practice could ultimately lead to global mergers between carriers.

As mentioned earlier, many barriers to entry remain in the airline industry long after deregulation. Aside from the obvious financial barrier, other factors involving the established major carriers present formidable obstacles for any airline trying to enter any of the more lucrative markets. Major airlines which were in existence long before deregulation all have well-established hub-and-spoke systems, usually have exclusive-use gate leases, and hold most if not all of the best take-off and landing times, or slots. The latter is illustrated in Table 1, which shows how a few major airlines have been able to dominate some of the busiest and most desirable airports in recent years.

Smaller airlines trying to gain entry to some of these locations find it nearly impossible, since the airports have leased most of their gates to a few large carriers. A 1990 government survey of the 66 largest U.S. airports showed that major, established airlines held long-term, exclusive-use leases to 85% of available gates. In some cases, all gates at the airport were under exclusive-use lease agreements. Such restrictions force airlines wishing to gain entry into these markets to sub-lease gate space from other airlines at a higher than normal cost. Table 2 gives a sampling of the percentage of exclusive-use leases in effect at six of the airports surveyed (USGAO, 1996).

Other impediments to entry include bonuses to travel agents, frequent flier plans, ownership of Computer Reservation Systems (CRSs), and existing code-sharing agreements (USGAO, 1996). All these factors contribute to the attractiveness of

TABLE 1
Percentage of Domestic Air Carrier Slots Held By Selected Groups in 1986, 1991, and 1996

Airport/holding entity	1/1/86	1/1/91	6/17/96
O'Hare:			
American and United	66	83	87
Other established airlines	28	13	9
Financial institutions	0	3	2
Post-deregulation airlines	6	1	1
Kennedy:			
Shawmut Bank	43	60	75
Other established airlines	49	18	13
Other financial institutions	0	19	6
Post-deregulation airlines	9	3	7
La Guardia:			
American, Delta, and USAir	27	43	64
Other established airlines	58	39	14
Financial institutions	0	7	20
Post-deregulation airlines	15	12	2
National:			
American, Delta, and USAir	25	43	59
Other established airlines	58	42	20
Financial institutions	0	7	19
Post-deregulation airlines	17	8	3

Note 1: Numbers may not add to 100 percent due to rounding.

Note 2: Several airlines that held slots have gone bankrupt, and in part as a result of the bankruptcy proceedings, some financial institutions have acquired slots. At Kennedy, for example, Shawmut Bank holds the slots operated by TWA. Similarly, in addition to purchasing slots, the incumbent airlines have built up their slot holdings as a result of the bankruptcies as well as through mergers with other airlines.

Source: United States General Accounting Office, 1996.

alliances as an economical means of entry into certain markets.

Effects and Benefits

Alliances and code-sharing agreements produce a variety of benefits to both the airlines and society in general. Employee job security is greatly enhanced and passengers enjoy smoother transitions on connecting flights when the connections are made through allied airlines. Airlines realize added revenues as part of the alliance due to code-sharing agreements and through increased traffic resulting from frequent flier links between partners. Table 3 illustrates the increase in passenger traffic realized by the USAir/British Airways alliance, which began in May of 1993.

TABLE 2
Airports Where Post-Deregulation Airlines Reported Difficulty Gaining Competitive Access to Gates, and the Leasing Arrangements at Those Airports

Airport	Total number of jet gates	Gates under exclusive-use leases	Major lease holder and date of lease expiration
Charlotte	48	43	34 gates leased to USAir until 2007
Cincinnati	67	67	50 gates leased to Delta with 9 leases expiring in 2015 and 41 expiring in 2023
Detroit	86	76	64 gates leased to Northwest until the end of 2008, with all but 10 under exclusive-use terms
Minneapolis	65	65	49 gates leased to Northwest with 16 leases already having expired and now on month-to-month basis, and remainder expiring at various times from the end of 1997 to 2015
Newark	94	79	43 gates leased to Continental until 2013, 36 gates leased to the other established airlines until 2018, and 15 gates reserved primarily for international use
Pittsburgh	75	66	50 gates leased to USAir until 2018

Source: United States General Accounting Office, 1996.

Alliances and code-sharing allow the airlines to remain financially independent while achieving many benefits from a market perspective. As an example, the Northwest-Continental alliance is expected to generate more than $500 million in pretax revenues after its fist three years, with Northwest receiving 55% and Continental receiving 45% (Field, 1998). This agreement will allow Northwest and Continental to gain many of the economic advantages of a merger without the cost or labor and antitrust problems associated with a merger. Under the agreement, both companies will have separate boards, management and headquarters, with one new director added to Continental's board to be named by Northwest (Field & Alexander, 1998a).

In addition, Continental will gain cooperative operations with Northwest's transatlantic partner, KLM (Continental Airlines, 1998b). Continental also has a transatlantic agreement with Air France, which has doubled the airline's revenues from connecting passengers since the inauguration of the agreement (Sparaco, 1998). However, the extent to which an airline will benefit from an alliance depends on the geographic scope of the agreement, the degree of operational and marketing integration between partners, and the division of revenues among partners (USGAO, 1995).

Alliances also provide many benefits to consumers, such as close schedule coordination between partners and shorter layover times between connections. Consumers choices are greatly enhanced through the offering of more combination of flights in various markets, providing competing options with minimal layover times. Most international travel arrangements involve several transfers along the way, and carries not involved in code-sharing alliances would require passengers to interline on several different airlines with less convenient layovers

TABLE 3
Number of Passengers Booked to Travel on USAir/British Airways' Code-Share Flights, May 1993 – December 1994

Quarter	Number of code-share passengers 1993	Number of code-share passengers 1994
I (Jan-Feb-Mar)	N/A	9,189
II (Apr-May-Jun)	914	20,058
III (Jul-Aug-Sep)	3,113	21,500
IV (Oct-Nov-Dec)	4,412	16,846
Total	8, 439	67,593

Note 1: Code-sharing arrangement did not begin until May 1993; thus, there are no data for the first quarter of 1993.

Note 2: Bookings are as of day of flight.

Source: United States General Accounting Office, 1996.

(USGAO, 1995). However, there is currently insufficient data to positively determine whether alliances have contributed to or caused any fare reductions (USGAO, 1995).

Opposition and Problems

While alliances and code-sharing agreements are very attractive to the airlines, there are some concerns that these arrangements may not be serving the best interests of the public. U.S. Government officials are concerned that these agreements may actually be detrimental to competition and create even more barriers to entry for emerging airlines. These concerns have recently prompted government regulators to pressure big airlines to reduce hub operations and open up slots at major hub airports, to avoid predatory pricing tactics and to make room for upstart airlines. Former Assistant Attorney General Anne Bingaman noted, "Code-sharing has the potential to be significantly pro-competitive... [but it can also be] a mask for anticompetitive arrangements between... competitors to allocate markets, limit capacity, raise fares or foreclose rivals from markets" (Carey & Ingersoll, 1998, p. 11). Senator John McCain, Chairman of the Senate Commerce Committee, recently voiced his concern over the flurry of alliances in recent months when he stated that the activity "only heightens our zeal to move forward with pro-consumer legislation to promote new airline entry" (Carey & Ingersoll, 1998, p. 11). McCain added, "We already face the risk of pricing the middle class out of the air travel market. This is something that we have to oversee carefully and force [DOT] to oversee carefully" (Field & Alexander, 1998b, p. 1). He has also indicated that he will ask the General Accounting Office (GAO) to assess the competitive implications of further airline consolidation. Additionally, DOT Secretary Rodney Slater has said that the DOT and DOJ will review all code-sharing and alliance agreements (Carey & Ingersoll, 1998).

It is clear that reduced competition is the biggest concern of those investigating the alliance issue, since many potentially harmful economic effects could result from decreased competition. Congress has begun to focus its attention on the nation's six largest carriers, all of whom are in negotiations for alliances which would create three giant alliances (United/Delta, Northwest/Continental, and American/US Airways) controlling at least 80% of the domestic market (Associated Press, 1998).

Government regulators fear that these strategic alliances have the potential to lead to a marketplace dominated by a few so-called "mega-carriers" that are not effectively competing with one another, or which prevent other carriers from entering the markets. Rep. Jim Oberstar, a member of the House Transportation aviation subcommittee notes that the alliances would create an "enormous economical force" that are "not mergers in the traditional sense, but their effect on the traveling public, service and fares may not be much different." (Associated Press, 1998, p. 1). The DOJ has stated that it will seek to block any alliance which would "restrain trade and lessen competition" (AP, 1998). Other potential effects of alliances are higher fares in smaller markets, increased competition for frequent flyer seats, and more consolidation of airlines (Field & Alexander, 1998b).

Opposition to strategic alliances doesn't end with governments. Some airline executives are opposed to certain alliances that would affect markets they currently serve. Nowhere is this opposition clearer than in the hotly contested alliance proposed between American Airlines and British Airways. Richard Branson, founder and CEO of Virgin Atlantic airlines, vehemently opposes the proposed alliance and has called the agreement "the most blatantly anti-consumer and anti-competitive proposal to be submitted..." to either the U.S. or British governments for consideration (Reed, 1998, p. 21). The issue is the number of slots that would be controlled by a combined AA-BA alliance at London's Heathrow International Airport, Europe's biggest and most important hub. If approved, the alliance would give American and British Airways 100% of the peak slots at Heathrow (Reuters, 1998). Stephen Wolf, CEO of US Airways, contends that the U.S. should negotiate an 'open skies' agreement allowing full access to all routes between the two countries with unrestricted route and traffic rights, with Great Britain ensuring that competition will be enhanced at Heathrow prior to giving approval to the AA-BA deal (US Airways, 1998). In addition, the European Commission has stated that the two airlines would have to relinquish approximately 300 slots per week before the alliance can be considered for approval (Reuters, 1998).

The American-British Airways alliance may be laying the groundwork for and setting the rules by which all subsequent strategic alliances are developed and approved. It remains to be seen how the agreement will be implemented, but one thing seems certain: both airlines are firmly committed to the agreement, and it will go through in one form or another.

Conclusion

Many U.S. carriers are seeking global expansion and economic advantage via strategic alliances and the establishment of expanded core operations at home and overseas. However, various government restrictions and other obstacles often hinder these efforts, which has left strategic alliances with other carriers the only viable option. Alliance and code-sharing agreements have emerged as business models that have been the fastest growing area of competitive advantage in the airline industry over the past three years. The trend is expected to continue to the point that the way airlines do business and compete with each other will be forever changed in the next few years (IATA, 1996).

If true economic advantages are to be gained through the joining of resources by two or more airlines, it will most likely come from the creation of a single controlling entity which unifies all aspects of the business under a central authority devoid of the divergent interests which currently exist in today's alliances. Only a true merger would permit such control and allow cost and revenue efficiencies to be achieved (Gibson, 1998). Nevertheless, the degree of magnitude of any economic advantage or gains realized from an alliance depends heavily on the geographic scope of the code-sharing agreements and the level of economic integration between partners. In other words, whether or not the airline industry will gain economically as a result of the current alliance trend depends on the specifics of each deal. Additionally, the last GAO study stated that there was insufficient evidence to determine whether alliances had resulted in increased or decreased competition, or lower fares. Benefits to consumers in the form of lower fares are yet to be determined (USGAO, 1995). These data will have to be studied further over the long run. For now, one thing is certain: Alliances and code-shares are here to stay, as they represent critical and important sources of new traffic and revenues for an industry characterized by razor-thin profit margins.

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