

## **The Impact of Liberalisation on Cross-border Airline Mergers and Alliances**

**Dr Kostas Iatrou**

*Secretary General, Hellenic Aviation Society*

6 Apostolidi Street 14578, Ekali Greece, Tel: +306932902050, e-mail: [kiatrou@aviationsociety.gr](mailto:kiatrou@aviationsociety.gr)

### **Abstract**

The airlines in their effort to extend their network to meet the needs of the globalised environment have had to interact with regulatory authorities whether in teamwork or in conflict. Alliances were the mechanism chosen or rather the only available to airlines to achieve their purposes. Alliance development was assisted by the domestic deregulation, the bilateral and regional liberalisation. Air France-KLM merger, followed suit by the Lufthansa-Swiss merger announcement, has changed the landscape of air transport and set the foundation stone towards air transport consolidation, which promises to offer a concrete possible source of competitive advantage in the form of efficiencies and synergies. This paper presents in the first part a theoretical overview of the deregulation and liberalisation evolution. Then it sets out the reasons that might push airlines to proceed to mergers at least on a regional level. Finally, the results of a questionnaire survey regarding the way airlines themselves assess alliance performance and view merger potential.

### **Introduction**

The main driver behind airline alliances has been the need to acquire global reach, provide customers with global coverage and meet the demands of the “global village”. While firms in other sectors, in such efforts to achieve external growth, have had the “luxury” of being able to choose at will between mergers/consolidations and alliances, airlines seeking to extend their networks have had to deal with a regulatory framework that dissuaded similar freedom of movement. This regulatory framework, in the form of ASAs, provided that individual states negotiate bilaterally the provision and exchange of air services and capacity rights between national territories and required that the majority of the capital and effective control of the airline be in the

hands of the designated State. These nationality provisions, which prevented the taking over of a foreign airline and prohibited the operation of domestic services in foreign markets, have forced airlines to resort to global alliances as a fall-back means of integrating markets and achieving growth.

Airline alliance evolution has been influenced by, and has itself had an impact on, the course of deregulation in many domestic markets, regional blocs, much as it has both felt the effects of and contributed towards the gradual liberalization and relaxation of the international air transport industry. Together, intergovernmental agreements and inter-firm strategies, have created a new environment that is offering new opportunities and challenges and have paved the way towards the much-awaited and needed consolidation of the air transport industry in the form of cross-border mergers.

Alliances cannot be fully understood unless the wider political and regulatory context they spring from is taken into account.

### **The Impact of liberalization on alliances**

#### *Alliance development and the liberalization trend*

International and national aviation policies and corporate strategies are acting upon each other in ways that have serious implications for the structures of international aviation, a symbiotic relationship which becomes even more obvious when observing how domestic deregulation, bilateral and regional liberalization have moved hand-in-hand with airline alliances. A distinctive feature of the current mega-alliances is that a US airline and a European airline form the core partnership in each. This pairing is by no means a coincidence, instead answers the specific needs of the airlines from these geographical regions and their corporate strategies. These two geographical regions represent the world's most important aviation markets. In 2004,

passengers carried on transatlantic flights represented 3.7 % of all passengers transported by air worldwide, partly because transatlantic flights connect the world's two largest domestic air transport markets, namely the European and the US markets, which account for 23.3 % and 29.2 % respectively of global air traffic (IATA 2005). It is therefore understandable that the authorities and the airlines from these areas have led and shaped international liberalization.

In order to better understand the origin and background of European Union and US airline strategies which resulted in alliance formation it is important to remember the peculiarities of the two markets.

European airlines have always given priority to intercontinental business over domestic operations; US air transport, on the other hand, originated as a significant domestic industry with a separate and specialized international sector. This can be explained as an accident of geography: the greater distances to be travelled within the US have favoured the development of a strong domestic airline industry, whereas in many European countries there is little market for domestic aviation because the mainly short distances, together with a fast, efficient railway network put airlines at a disadvantage. Many European airlines have always had, and still have, a larger stake in international and long distance markets than US airlines. For major European flag carriers, access to large foreign markets has always been crucial because historically they have depended substantially on long haul rather than on their rather limited domestic traffic for their revenue, with some European airlines deriving more than 30 % of their profits from transatlantic services (Egan 2001).

Deregulation (1978) left the US air transport industry with six major airlines, three of which – American Airlines, Delta Air Lines and United Airlines – controlled 58 % of domestic traffic. They developed hub-and-spoke networks to effectively cover the entire nation. These hubs were built away from the traditional ports of entry for international traffic such as New York, Boston or Chicago, instead favouring the likes of Charlotte, Cincinnati and Pittsburgh. By 1993, some 70 % of domestic passengers passed through

these highly concentrated traffic hubs, and gleaned enough traffic feed from their huge domestic networks to sustain international services. These so far domestic airlines turned to international routes, which were attractive because they were more profitable than domestic flights. Before 1978 transatlantic traffic from US was dominated by the two US specialising on international airlines, Pan Am and TWA, although they did not have large domestic feeder networks. These two airlines had concentrated too much on international aviation and when the European airlines, revived after the war, began to concentrate on transatlantic routes to compensate for the routes lost with decolonisation they saw their transatlantic market share shrink. With the lower cost structure the US airlines arising from deregulation during deregulation, they could offer lower fares and thus take away traffic from established European airlines. The main obstacle was regulatory. Newcomers had to obtain authority under the existing ASAs to operate international routes. They took over from Pan Am and TWA the traffic rights and pushed US Authorities to renegotiate less restrictive air transport services agreements, the so-called “open skies agreements”, that would enable them to operate more flights from more points in the US at higher frequencies and capacities, inaugurating the move towards the gradual liberalisation of international air transport.

At the European level, liberalization as part of the European Union single market program has resulted in cabotage<sup>4</sup> restrictions being removed and in bringing about increased competition in the regional airline market, but the whole process was implemented so as not to seriously hamper the competitive advantages of the flag carriers. There was initial uncertainty about the external consequences of liberalization and fears about the effects deregulation would have on the international stakes of European Union airlines. After US airlines began their aggressive international expansion programme, European airlines resisted bilateral agreements allowing unrestricted capacity increases and route expansion. This reluctance was due to the need of the airlines (particularly Air France and Lufthansa) to resist

---

<sup>4</sup> Cabotage or eighth freedom rights: the right granted to a foreign airline to operate in another country's domestic route network, that is to carry passengers between two domestic points of another country.

pressures for liberalization until they had undergone the massive restructuring necessary to cope with the pressures of privatization and the challenges created by the Single Aviation market.

As in the US, with privatization and deregulation came consolidation in the domestic markets with the traditional flag carriers securing or even enlarging their presence. Domestic mergers – Air France, UTA and Air Inter in France, British Airways and British Caledonian in UK – strengthened airlines and helped them play a stronger role on the European and international scene. The existence of a common market in Europe meant that there were no restrictions on complete takeovers or mergers between airlines operating within the territory of the European Union. But air transport services between Member States and third countries continue to be regulated by traditional ASAs. Thus, for one airline to take over another's operating routes outside the European Union was considered unproductive, as it would "denationalize" the airline undergoing the takeover and possibly threaten the validity of its bilateral agreements. The intra-European alliances which developed were therefore based on a regional system structurally differently from that of their North American counterparts: instead of the four or five "mega-carriers" the consolidation process had produced in the US, in Europe a multi-tiered set of alliances between major and minor airlines emerged, with smaller airlines acting as clients, "feeders" for larger hubs.

By 1992, with deregulation completed on both sides of the transatlantic market, the major European Union and US airlines were essentially facing the same dilemmas: both had very large stakes in North Atlantic routes, both had been hit by the slump in traffic caused by the Gulf War and both were anxious to draw more directly on traffic within the other's home markets.

Europeans started looking at the US market, which in terms of traffic was even larger than that created through the emerging European single market. This US market was becoming increasingly rationalized into hub-and-spoke systems, with some hubs often located well away from the traditional East and West Coast points of entry for international traffic. The dilemma of EU airlines was that, even assuming they could obtain international authority to fly to the

hubs concerned, under US law they could not organize their own hub-and-spoke systems within the US.

US airlines had other concerns: although they could expand their shares of international traffic with the consent of liberal foreign governments and thus draw traffic from other European hubs, cabotage rules prevented them from setting up their feeder networks within Europe. Nor could they buy into national airlines, given the restricted foreign ownership rules, and even if it had been possible it would probably have turned out to be prohibitively expensive. What they needed was to control feed from European markets on to their transatlantic flights at levels and through hubs comparable to those available from their US networks.

In addition, the Single European Aviation Market hindered the attempts of US airlines to create hub-and-spoke systems within Europe, as its establishment resulted in the loss of some of their fifth freedom rights. For example, a US airline could no longer fly from Rome to Paris once the European Aviation Market was considered to be unified, because such a flight required cabotage rights the Americans lacked. US airlines were therefore forced to enter into alliances with European airlines operating in these markets, to preserve such flights through code sharing. Prior to the change, various foreign airlines, including several from the US, had obtained fifth freedom rights to carry traffic between national capitals as an extension of transatlantic services. In a single market logic, services of this kind which had previously been defined as “international” flights became “domestic” instead and were thus prohibited under the cabotage clause.

In the wake of deregulation, with a more competitive environment, the airline industry became increasingly concentrated. The best solution for both US and European airlines was to establish alliances, which represented the mechanism that could provide indirect access to restricted markets. Although they were now liberalized, US and EU airlines were looking for ways to get government support in either securing their position in the domestic markets or gaining access to new markets through alliances and “open skies”

agreements. Once this support was obtained, the appropriate national or regional authorities would then give the go-ahead to the alliance efforts.

Liberalization has been the great catalyst behind the formation of airline alliances. Without liberalization it would have been impossible for airlines to cooperate closely enough to find the common ground enabling them to reap mutual benefits. Full deregulation in the European Union, in combination with open skies agreements, have enabled airlines to access new markets, a process that could never have occurred within the confines of the Chicago bilateral regime.

### **Air Transport after deregulation and Airline Alliances: a brave new reality**

The aim of domestic deregulation and bilateral and/or multilateral liberalization was to create “more competitive air services”, or in other words to foster competition among airlines by removing regulatory constraints. The idea was that by promoting an international aviation market with unrestricted entry and competition amongst the most efficient carriers on a multilateral and global level, unprofitable companies would fall by the wayside and this would lead to greater efficiency and, ultimately, falling air fares, higher flight frequency and greater customer choice.

These aims have been partially fulfilled. At domestic and intra-EU level there are relatively few constraints on the establishment of new airlines. By contrast, entry on international routes is still governed by ASAs, or at the very best open skies agreements with restrictions on routes flown, numbers of carriers and frequencies. There have been some new entries and fares on many routes have become much more convenient, but air transport is still neither as freely competitive nor as efficient as was originally hoped. The financial crisis that has been plaguing the industry since 2001 is not the only factor to blame for this. Indeed, the very mechanism airlines have chosen to deal with the demands and opportunities of the new situation, i.e. alliances, has been instrumental in helping incumbent airlines maintain a degree of control on certain markets.

Following the attacks of 11 September 2001, the outbreak of SARS and war in Afghanistan, the Arabian Gulf and Iraq, the airline industry has been under serious financial pressure. It has certainly undergone other crises in the past, but there has never been such an unrelenting run of bad luck. The financial effects have been so dire that several airlines have been unable to break even and some, such as Sabena and Swissair, have disappeared altogether. And just as the global economy seems to be inching towards recovery, air transport is suffering the fallout from the tension in Iran and the Lebanon-Israel conflict, as it meanwhile finds itself facing permanently higher fuel prices<sup>5</sup>. With airline traffic so closely related to economic activity and the idea of safety and security, a downturn in the market was and is inevitable. But the drop in demand is not the only factor that has and will continue to affect it; higher costs will also have to be borne, including higher insurance premiums and other outlays on security and safety, airport charges, etc., forcing governments (especially the US) to come up with ways to provide financial support.

Meanwhile, domestic deregulation and bilateral and/or multilateral liberalization have changed the rules of the game by allowing entry to some new players, mostly in the form of Low Cost Carriers (LCCs), although an ideal condition of unrestricted entry has not yet been achieved. LCCs constitute the only credible threat of new competition, although in reality they offer a somewhat different product which does not perfectly substitute the air service of the established airlines. Nevertheless, their entry has been the main factor in driving airfares downward, especially on intra-continental, point-to-point service.

Airline alliances that exploited the opportunities offered by the still partially deregulated international routes often softened competition for partner airlines, and according to some even raised the existing entry barriers.

---

<sup>5</sup> Much higher, in fact: hedging for the first two quarters of 2007 sees levels ranging in the 70-75 dollars per barrel region. A three-fold increase with respect with just a few years ago.

As Mr Michael Gremminger<sup>6</sup> of the European Commission put it, certain alliances seem to have been formed not only to achieve the necessary scale to compete globally, – but also for less noble causes: to control certain markets, especially those protected by entry barriers, to preside over slots at congested airports and to exploit traffic rights. Seen from a regulator's point of view, airline alliances have made it possible for the partners they link together to enjoy a kind of monopoly. This view is strongly contested by the airlines themselves, and the conceptual dispute has been at the heart of the controversial relationship between members of alliances and antitrust authorities for the past ten years.

Airline alliances have enabled carriers to increase their dominance at their respective hubs. In major hub airports, there is a clear tendency towards single carrier dominance, which means that significant portions of the passenger movements are accounted for by a single airline. In nine of the top 25 airports, the dominant carrier is responsible for over 50 % of the emplacements at the airport (OECD 2000). The demand and cost side economies of scale and scope enhanced through alliance cooperation give larger airline networks a competitive advantage over smaller carriers. Hub-and-spoke airlines tend to be dominant on spoke and hub-hub routes and jointly dominant, with the partner's networks, on routes to and from other networks' hubs.

Most new entries, therefore, either offer services complementing those of the incumbent airline, for example spoke feeder service, which in spite of being pro-consumer cannot be considered a form of competition, or provide services from existing network hubs, as bmi British Midland has done. Still others, such as Virgin Atlantic, focus on routes with a high number of point-to-point services. Certainly, the latter strategy does foster some form of competition, but this can occur only in airports able to sustain the existence of several carriers, such as London-Heathrow. This may be why the United Kingdom is the only market to support three major scheduled airlines: British

---

<sup>6</sup> The quotations cited in the paper were obtained during a series of interviews undertaken for the needs of the book "Airline Choices for the Future" to be published by Ashgate in April 2007

Airways, Virgin Atlantic and bmi British Midland, each with its own extensive international network. One of the notable features of the UK market is the high number of non-stop services available from London. 22 US cities are served non-stop from London, compared to 15 from Frankfurt and ten from Amsterdam (OECD 2000), and they represent some of the most heavily travelled routes in the world. In all other cases, airlines have managed to control a high share of the total traffic at their hubs.

This competitive advantage is further strengthened by slot constraints at many airports, especially those which are heavily congested. Route competition depends on the availability and quality of take-off and landing slots at specific hours. The slot allocation mechanism, which confers grandfather rights<sup>7</sup> on incumbent airlines, adds to the natural scarcity of slots. Thus, the incumbent airlines control a higher proportion of slots at peak times. New players may also have difficulty securing advantageous contracts with ground handling companies that already have contracts with other airlines. If an airline dominates an airport, it is usually also the dominant or sole supplier in the ground handling market.

Despite some regulatory provisions to ensure slot divestiture, and others citing access to airport facilities as a precondition for alliance cooperation, there have been few cases where entry barriers were lowered sufficiently to allow new competitors through to such markets. This is seen by cartel authorities as an explicit sign of the way alliances suffocate competition, whereas the alliance partners themselves claim that the lack of new entries – in spite of the favourable conditions created – is proof that such a hostile stance is uncalled for. The most powerful way to erode dominance of one or more airlines at a single airport is to increase capacity, either by expanding existing facilities or by building new airports serving the same area. But such expansion inevitably implies major costs, the reaction of environmental groups and that of the wider public.

---

<sup>7</sup> Grandfather rights are the convention by which airlines retain the right to use particular take-off and landing slot times at an airport because they have done so previously and continuously.

Airline alliances have enabled incumbent airlines to strengthen their position in the market – which is exactly why they were formed in the first place – but this does not mean they shield partners from market changes, particularly the rise of LCCs and the shift in demand for air transport services, a phenomenon closely related to the emergence of LCCs.

Another important consequence of the airline crisis is that both governments and the public – at least in Europe – have accepted that airlines should cease to be regarded as national status symbols. Most countries are now convinced they are better off with a smaller airline securely harboured in an alliance – or better still in a merger – than with a larger airline that guzzles away at public money to survive. People have given up their “romantic” ideas, to use Gantelet (European Commission) and Windmuller’s (IATA) expression, about their national flag carriers, especially when these are poorly managed and do not provide the service expected of them. Consumers nowadays are much more interested in reliable service and lower fares. Chris Tarry (CTAIRA), however, raises an interesting point when he mentions that the demise of an airline is a rather complicated issue, as it may bring about a financial blow to the main airport of the country of the flag carrier, with the resulting consequences on employment, procurement in the area, etc. Brussels is an often cited example of a hub airport that was badly hurt by the demise of its main client, Sabena. This is especially true for the airports of Central Europe, where the proximity of many airports may eventually lead, in the eventuality of mergers, to their closure or downgrading. Vienna airport could turn out to be a case in hand, for instance, should Lufthansa ever buy out Austrian Airlines. This may explain why the Dutch government and KLM management have insisted on making certain in the Air France-KLM deal that Amsterdam airport will retain all its services for a period of ten years.

Another issue that airlines and alliances will have to deal with are the developments in aircraft technology. Large aircraft such as the Airbus A380, destined to be used on international high-density routes, will expand capacity and reduce costs by raising the overall number of passengers per flight. At the same time, new smaller aircraft such as Airbus A350s and Boeing 787s

will allow competing alliances or merged airlines to provide direct services on long distance, thin city pairs such as San Francisco and Copenhagen or Hong Kong and Oslo. Today, no airline would dream of undertaking such a service, because it would require a Boeing 777 the carrier would be unable to fill.

### **Reasons pushing airlines to merge**

Global airline alliances have developed in response to the increasing liberalization of aviation markets and the drive for efficiency in international commercial activity. But with deregulation and liberalization completed and airline alliances formed and established, carriers have still been facing a number of serious problems: overcapacity, reduced yields and uncompressed costs. After the events of 11 September 2001 almost all airlines proceeded to carry out massive capacity adjustments and cost-cutting programmes, personnel and wages reductions, but regardless of these measures most of them have been unable to prevent losses. Under the emerging realities and new threats, the need to limit costs and achieve efficiencies becomes even more compelling.

In 1998 alliances were producing “sizeable cost savings”. At the time, strategic alliances were expected to enjoy as much as 70-80 % of the benefits that would have been achieved through an outright merger. Alliances were promising to bring down costs, but the true magnitude of their effects in this sense appears to have been small. Analysts and airlines believed that alliances would achieve efficiency through synergies, since many of the elements which are present in a merger also appear in alliances, at least in theory. However, a decade of alliance cooperation has shown that while alliances may have succeeded in increasing traffic and expanding networks they do not seem to have scored highly in the area of cost reduction and operational synergies. Perhaps the main reason they have fallen short of the mark is due, as Chris Tarry (CTAIRA) believes, to a reluctance of small carriers to integrate, because of fears that becoming too dependent on alliances is tantamount to being bought out. Airline managements started wondering whether alliances are the right medium to deliver on costs and

whether mergers and consolidations is the only way to secure a sustainable future for the airlines and a viable and competitive airline system. The European Commission officially supports that consolidation among its majors may be inevitable and even desirable if they are to retain a leading role on the world stage.

The attractiveness of mergers lies precisely in the promise they hold, that is to deliver the efficiency that may result from commercially powerful and financially viable airlines as well as from a far more competitive and supple global airline industry.

Given the novelty of the phenomenon, there is still no widely and/or officially accepted definition of airline cross-border mergers. Mohamed Elamiri of ICAO has defined cross-border mergers as: “acquisitions or operational integration of airlines of different countries under a single holding company”.

The main difference between alliances and mergers has to do with ownership and control: mergers lead to a single entity, whereas alliances do not affect legal ownership and are based on revenue sharing and capacity coordination with loose links, with every company remaining independent.

Airlines, like all global companies today, need to be fast, efficient, profitable, flexible, adaptable and future-ready, with a strong market position. As most experts agreed in a series of interviews conducted for the purposes of this book, the main drive behind mergers in the airline industry is “control”, whereas alliance partners have to “negotiate, compromise, convince”. According to Gilles Gantelet, of the European Commission, the main drive behind mergers is the need for “full operational and commercial control” in order “to face the global situation at the global market”, because in a merger you have “one strategy, one executive board and you are developing all the products in the same way”. Mergers seem the only safe way to achieve synergies and secure a single strategy. Mohamed Elamiri, of ICAO, believes mergers provide “a better control of operations”, whereas Michael Gremminger, of the European Commission, expressed the opinion that the main reason behind mergers is the need to achieve efficiency by reducing the cost base and improving the network. The main difference between alliances

and mergers is that although they actually have the same aims, mergers offer a better level of control and achieve efficiency more quickly. A merger potentially allows 100 % consolidation, while in alliances integration is much more limited.

In other words, mergers can better achieve the objective for which alliances were formed. Alliances do not seem to have provided an efficient enough vehicle for the growth in earnings which the capital markets could require. Furthermore, such control could reduce airlines' vulnerability to economic and competitive pressures and increase their flexibility to design a range of services. As Chris Tarry suggested, airlines need to come up with "more tailored products" that will provide customers with choice, customization and flexibility. The three alliances essentially differ only in identity and membership – otherwise they can be seen to be pursuing the same objectives. From a product point of view there is no real reason to prefer one alliance/airline over the other, since they are competing with similar tools and offering comparable products. Chris Tarry has often stressed that a strong financial performance will only be achieved when airlines align their products to the price passengers are prepared to pay. A merged entity with one strong management structure which decides "we are going in that direction" seems to be in a better position to proceed towards redesigning products and services.

There is no real precedent in cross-border mergers which enables researchers and analysts – or the carriers themselves – to assess their potential. The only close alternative is the background of US consolidation, and this is because of the sheer size of the US domestic market and that of the airlines involved in it. But US carriers did not have to bother, when merging, with issues such as national identity, state ownership or the possibility of losing traffic rights. Still, the merger experience in the US has certainly brought about two important results: market power produced through the exit of a competitor and cost savings from scale and scope economies. In the US, airline mergers also resulted in greater concentration at a reduced number of large hubs and the closing down or reduction of activity at smaller

hubs, reallocating flights to the large hub. A merger wave in Europe could lead to the eventual closing down of second-tier hubs such as Zurich, Amsterdam, Rome, Copenhagen or Vienna. US major airlines operate multiple hubs but they are geographically dispersed throughout the US, which enables them to serve different flows with each hub. Ordinarily, it makes sense for a merged company to focus on one hub, avoiding the hurdles of managing two airports situated as closely together as Paris is to Amsterdam, or Frankfurt to Munich. But European airports suffer from capacity restrictions, the territory is densely populated and the closing down of airports seems less viable.

### **Airline executive opinion about airline alliances and mergers**

The executives of the airlines that are part of the strategic alliances (that is 31 out of the 32 allied airlines) were asked to express their opinion regarding alliance performance and the potential evolution and development of cross-border mergers and how such developments can influence not only their own airline but also the future air transport structure.

All executives agree that the aim of alliances was the creation of a global network that serves many destinations without the airlines incurring extra cost. In this way, passenger traffic increase was observed in combination with the creation of a global FFP. This has resulted in a rise of revenues and a corresponding reduction in operating cost. Even if this cost reduction has not been achieved yet, or achieved at the desirable degree, it is certainly one of the major future goals of alliances. In essence, the airlines can through alliances, as they state, “satisfy customer demand with more global products” and achieve “global presence without global cost structure”. In parallel, alliances permit airlines to increase their competitiveness and gain market share.

In general the accession and participation in the alliances is considered successful. While one third of participants rate their alliance cooperation as “excellent”, the rest believe that the course and operation of the alliances has

been so far “good”. A European regional carrier expressed some reservations and preferred to take a neutral stance.

Almost all participants believe that joining the alliance grouping has led to an increase in traffic, load factor and revenue. While two thirds of participants expressed the opinion that fares have not been influenced, the rest declared that fares on routes operated jointly by partners have increased. A large proportion of participating airlines affirms that costs have registered some reduction.

#### *Airlines’ perception of the drive towards consolidation*

Airline executives were also asked to assess how the airlines view the potential of mergers, that is, to identify whether they believe that there is indeed an imminent wave of cross-border mergers and a consequent restructuring of the air transport system. 75% of the airlines say that consolidation is slowly but surely gaining momentum but only 13% believe that there is a strong drive towards a more consolidated industry. The answers given are somewhat differentiated from those given two years ago (Iatrou 2004), when 60% of the respondents of a survey on alliances had stated that alliances were the final destination of airline cooperation. It should be born in mind though that after 2001 airlines worldwide, confronted with falling demand, faced serious financial problems, which forced them to concentrate on efforts to secure their survival, to adopt massive cost-cutting programmes and therefore moved more cautiously on cooperation strategy. It is only during the last year, now that that most airlines have set their house straight, that the economic situation seems to stabilize – despite the spiralling increase of fuel – and traffic is on the increase, and that the balance of power and the distribution of partners among alliances seems to even out, that airlines have begun again to look around for cross-border mutually profitable forms of cooperation.

Despite the fact that the respondents agree that mergers do gain momentum, 37% of them have stated that alliances will stay as they are and 26% believe that alliances will continue to develop and move to closer integration without proceeding to mergers. These answers may seem

contradictory on the surface but on a deeper level they may simply mean that mergers and alliances will co-exist. The small percentage of airlines that express an uncertainty over the future of alliances perhaps represent those airlines looking around for realignment. Finally, 17% say that the merged airlines will focus more on mergers than alliances. This low percentage clearly shows that mergers will not disturb the smooth functioning of alliances and there will be no reaction from the other partners in the alliance. What however becomes evident from these answers is that further integration, whether it will take the form of mergers or of closer cooperation between allied partners, is the new rule of the game in the air transport arena.

Alliances play a very important role in the strategic plans of airlines. But what is much more intriguing is that 36% believe also that mergers are a crucial part of their strategy and 6% of the carriers give precedence to mergers over alliances as a significant strategic move. That gives us 42%, which means that almost half of the airlines participating in alliances are, one way or the other, contemplating the possibility of mergers. There is certainly, at the same time, 36% of the respondents who believe that cross-border mergers are somewhat more marginal and put a premium on alliances and this finding is confirmed by the fact that 65% mention that cross-border mergers are a choice for the airlines and not a necessity.

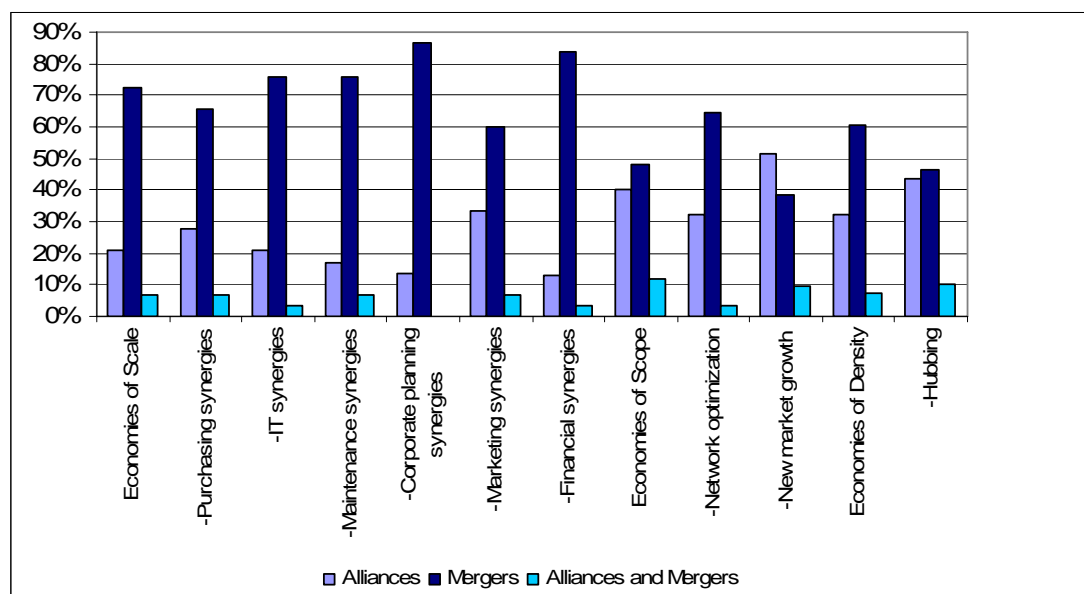
#### *The impact of alliances and cross-border mergers on airline performance*

Mergers as a form of airline cooperation largely outweigh alliances in the production of positive effects on airline operations. The only category in which alliances present more positive aspects is in that of economies of scope and more specifically in the subcategory of new market growth; a quite plausible finding since a merged carrier, no matter how large the merged airlines are, cannot match the network reach of a eight- nine- or sixteen-member alliance. After all, the main drive behind alliance formation was, as the airlines themselves stated, the desire to expand their geographic scope of their network so as to achieve global scale (Iatrou, 2004). In the area of hubbing, the results do not give a clear precedence in one form of cooperation over the other. Alliances have so far operated in a way so as to take the most out of

the hubbing system and the resulting economies of density with each partner feeding traffic to the other. A merger will most probably entail network integration, even network rationalization, which may mean that the overall network structure may change and some airports may lose connections while others may have more connections. Although it is much more efficient to close a duplicating hub and concentrate resources on the stronger one (Duedden, 2005), it is not certain that the merged airline will reduce the number of hubs as other aviation experts claim that mergers would lead to an increase in the use of the hubs of the two merged carriers. But in polycentric regions such as Central Europe other means of transport, especially trains, may replace aircraft to the detriment of smaller hubs, which will be downgraded, at best, to regional feeders to the big players that control the large hubs. In other words it remains to be seen whether the merged partners will maximize economies of density out of a single hub or they will pursue a multi-hub strategy selling it as a competitive advantage and positive differentiation criterion.

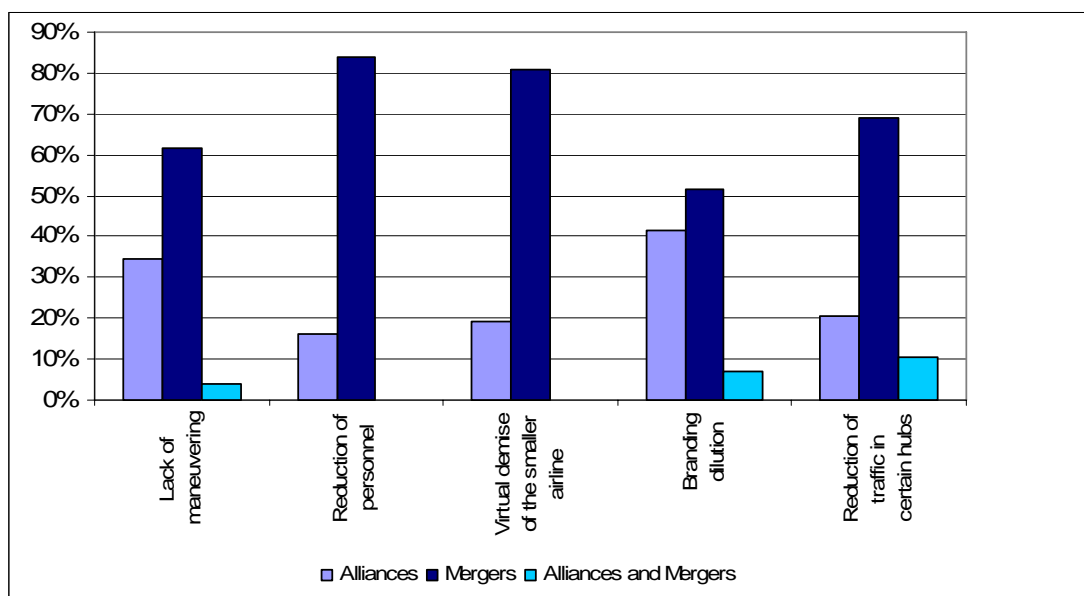
The most positive aspects of mergers appear, according to the respondents, in the area of economies of scale: corporate planning synergies followed by financial synergies, IT synergies and maintenance synergies. It seems that a strategic alliance does not allow the same type of cost synergies of a full merger. This result clearly shows that alliances have not been able to produce significant benefits in the area of cost synergies. None of the three major alliances have yet engaged actively in joint purchase of aircraft or in joint investments in information technology systems and customer databases, all those cooperation aspects that promise cost-effectiveness. All respondents agree that only cross-border mergers can more effectively bring about scale benefits and synergies as well as better quality decision making.

**Figure 1: Benefits of alliances and cross-border mergers on airline operations**



It is not the positive impact of mergers but also their negative aspects that are by far greater than those of alliances, with the reduction of personnel being the most negative. Labour costs are certainly the single most important component of total airline costs, accounting for 25-30% of total operating costs and all airline management would like to reduce it but they know very well that, given the unique leverage airline unions enjoy, this cannot be achieved without serious social and even political reaction. The second most adverse negative aspect of mergers is the threat posed to the existence of the acquired airline, as the mergers of two airlines would result in the demise of the smaller carrier. Next in ranking as the most negative aspect of mergers is the reduction of traffic in certain hubs since it is expected that the new merged entity will concentrate on exploiting the traffic out of the hub that will be the most profitable for the new company. Interestingly enough, the idea of brand dissolution does not appear to be considered a serious problem by the respondents whether in the case of alliances or mergers.

**Figure 5: Negative impact of alliances and cross-border mergers on airline operations**

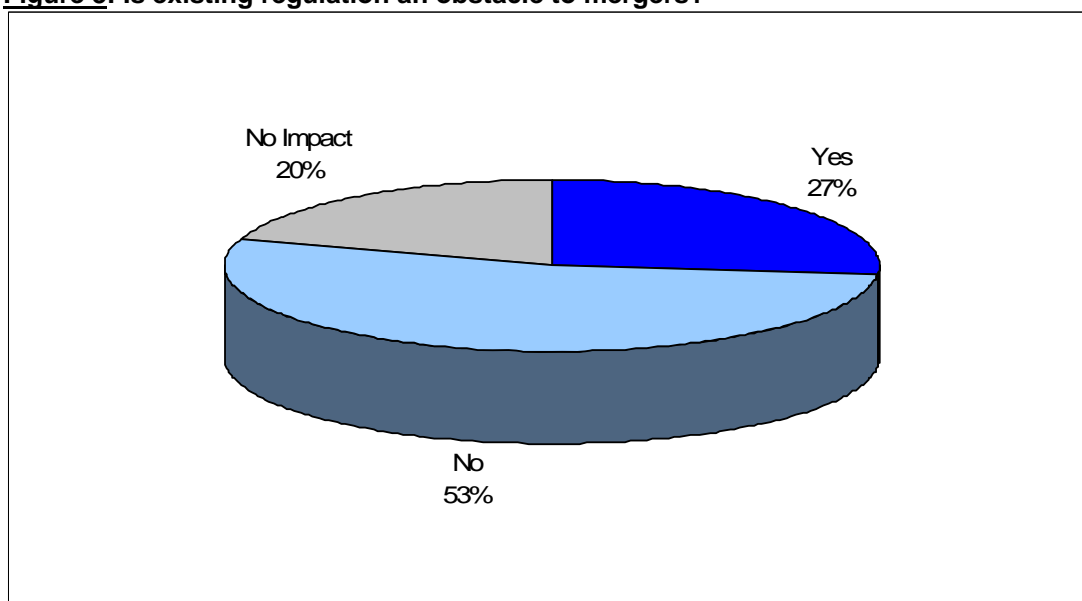


### The possible evolution of mergers

The airline executives were then asked to express their opinion in relation to the time evolution and the form mergers will take.

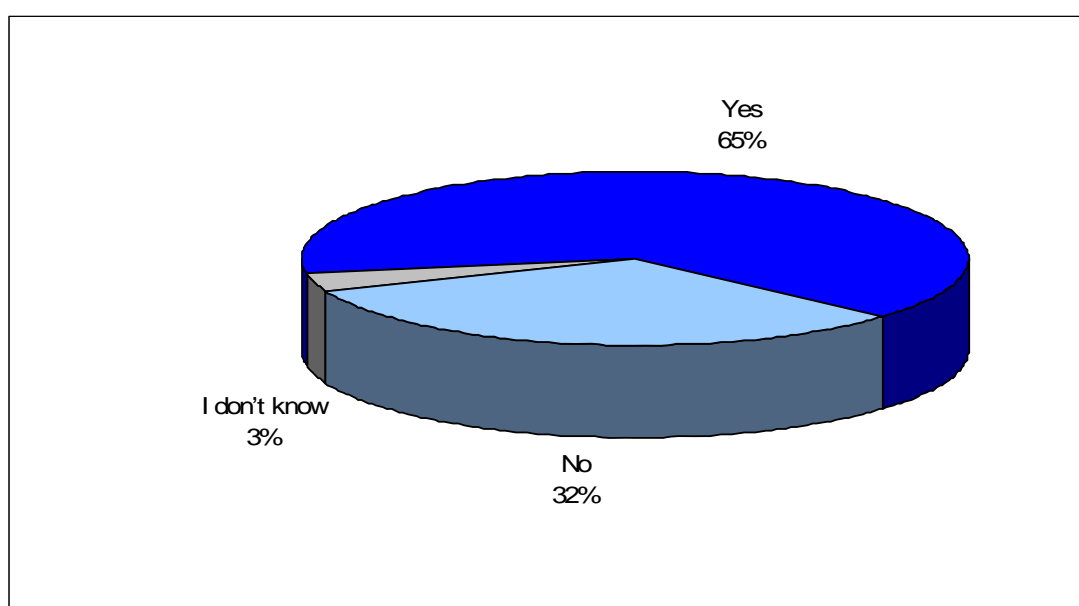
Most of the respondents (44%) consider that in the short-term (1-2 years, 44% of respondents) and medium term (3-5 years, 52%) new cross-border merger will be effected, and even cited as possible pairings those between British Airways/Iberia (20% of respondents), TAP/Varig, Lufthansa/Austrian, Singapore/Qantas and Air France/Alitalia with 10%.

**Figure 3: Is existing regulation an obstacle to mergers?**



Much of the literature on air transport has long claimed that if the clauses on national ownership were eased or lifted, this would remove obstacles to the consolidation needed in the industry. The respondents however, (53%) don't believe that regulation was and has been the reason that has prevented airlines from proceeding to mergers is regulation. The latest development with the Air France-KLM merger seems to confirm their views. In this case a new holding company was created and the two carriers continue separately their flight operations so as to circumvent traffic and flight rights restrictions. Competition and regulatory authorities were able to accept this complex governance structure and to interpret this merger pairing in a relaxed market-oriented way.

**Figure 4: Open skies agreement of US and EC is a prerequisite for European and North American consolidation**



The overwhelming majority of the respondents believe (65%) that the open skies agreement between EU and US is a prerequisite for European and North American consolidation. Given the magnitude of intra-North America's traffic – 29.2% – of the world traffic flows based on IATA, 2004 – and of the intra-European – 23.3% – as well as the traffic between these two areas – 3.7% – (in total North American and European carriers control 56.1% of world passenger traffic) – in correlation with the fact that most major carriers

operate in these areas, it is easily understood that such an agreement will be an important event in liberalizing the regulatory framework on a global scale. But whether this agreement will lead to cross-continent – that is, Europe-North America – mergers, remains doubtful given the US sensitivities in defense and national security issues (Fly America).

The most serious problems a merger initiative might face, according to the respondent airlines, would arise from the competition authorities (4.23) followed by labor issues (3.97). Mergers will certainly raise regulatory concern in terms of potential adverse impact on competition and consumers. Competition authorities will consider mergers on the case-by-case basis taking into account the current network structure of the prospective merger partners as well as the actual and potential competition on the routes involved. But another issue they will certainly consider and will bend their reaction to consolidation is whether an airline – whether flag carriers or not – can survive without being acquired.

The form that future cross-border mergers will most probably take is the acquisition of one airline from the other as almost half of the respondents have stated (49%), just as it happened in the case of Air France/KLM and Lufthansa/Swiss. Experience has shown that merger attempts where a new entity was established, as in the case of Alitalia/KLM in the early 2000, failed mainly as a result of the difficulty in managing an entity in which neither of the airlines had effective control.

Even though a cross-border merger between smaller or medium sized airlines would give the merged partners the possibility to strengthen the position of the new entity in the market and inside the alliance, 70% of the respondent airlines have stated that cross-border mergers will have the form of a major airline acquiring a smaller one. It seems thus that it is the big players that pull the strings of the consolidation game. This does not mean however that the possibility of a “confederation” of smaller regional carriers should be excluded.

59% of the respondents believe that cross-border mergers would strengthen the position of the merged carrier inside the alliance but if this will

affect the other airlines of the alliance depends on the case-by-case basis, that's why 28% mention that there will be no impact. Alliances are made up of a significant number of allies, thus any merger will not significantly alter the balance of power. After all, majors were and are the centres of gravity of all three alliances and it is them that will determine the course of both alliances and mergers.

Even though cross-border mergers so far, as those between Air France/KLM and Lufthansa/Swiss, have been effected between airlines that did not participate in the same alliance, 68% of the respondents have stated that future cross-borders will be effected between airlines belonging to the same alliances and such mergers will result in the strengthening of the merged entity within the alliance. It is certainly easier for two airlines that already co-operate on a bilateral level within the alliance to proceed to merger as they have built some level of trust and compatibility of operations. Furthermore, alliance membership seems to a large extent to have been fixed, thus no major realignments are expected.

As far as the question of multilateral cross-border mergers is concerned, answers diverge greatly as only 55% of the respondents dismiss such a possibility. Some of the respondents that have rejected this eventuality stated that the creation of a cross-border merger between two airlines is already too challenging of a task and quite difficult to materialize, which makes even more difficult to visualize the mergers of three carriers. Efforts within the framework of a tripartite attempt would be further hampered by the challenge of naming the new entity and by the concerns of competitions authorities and the increased cultural differences. But if indeed one of the future mergers is the one between Air France-KLM and Alitalia, this will be the first tripartite merger.

More than 2/3 of the airlines said that there will be cross-continent mergers. 75% of the airlines do not accept the statement that alliances are hard to govern, lack promised synergy benefits and have to a large extent failed. From the analysis of the questions it results that alliances have failed to deliver the expected synergies only on the scale level. Airlines are proceeding to mergers not out of dissatisfaction from the performance of alliances but

because they want to attain growth and have a better control over their operations.

## **Conclusion**

Global airline alliances have developed in response to the economic demand of global markets and to the opportunities provided by deregulation and liberalization initiatives. These cooperative agreements initially took the form of simple code share agreements; but as deregulation started to take effect in the European Union and a Single Internal European Aviation Market was created and as the US authorities pursued more “open” and less restrictive bilateral air services with other countries, the horizontal links between carriers took the form of deeper and more complex cooperation.

International alliances appear to be crystallizing around three major international groupings as these have expanded to include virtually all the major European and US airlines flying across the North Atlantic as well as an increasing number of airlines in other continents.

There are many that have argued that airline alliances are simply a second best solution, the only viable alternative, because had it not been for the regulatory constraints which make a carrier’s traffic rights dependent on the nationality of its ownership, airlines would have moved to mergers which seem to hold the promise of efficiencies, synergies, cost reductions, scale benefits and better control over operations. With a worsening financial environment and with restrictive bilateral agreements being gradually replaced by multilateral agreements between groups of countries, usually on a regional level, airlines are reassessing their priorities and are considering whether mergers and consolidations is the only way to secure a sustainable future for the airlines and a viable and competitive airline system.

It seems that there will be some merger activity within the next five years on an intraregional level -and more probably within EU- but the early stage of consolidation does not allow predictions on how the future landscape will look like. It is probably going to be a long kind of process.

But what is certain is that whether the air transport industry moves toward greater liberalization or not, the impact of such liberalization will depend as it did in the past on the continuous interaction between airlines – and their strategies – and the public bodies and the regulatory framework they impose.

**References:**

- Duedden, J-C. *Consolidation and its implications for long haul direct travel*, given at the 9th Annual ATRS World Conference in Rio de Janeiro, Brazil, 2005.  
  
(unpublished), available from 7 July 2005.
- Egan, M. *Creating a transatlantic marketplace: Government policies and business strategies*, give at American Institute for Contemporary German Studies, The Johns Hopkins University, Washington, D.C. 2001.
- IATA (2005), *World Air Transport Statistics*, 49th Edition. (Montreal: International Air Transport Association).
- Iatrou, K. (2004), *The Impact of Airline Alliances on Partners' Traffic* (Bedford: Cranfield University).
- OECD 'AIRLINE MERGERS AND ALLIANCES', *OECD* [website], (updated 1 Oct. 2006) <<http://www.oecd.org/dataoecd/1/15/2379233.pdf>>