

Workshop: Crisis in Aviation: Reinventing the airline business

Bremen 26th / 27th June 2003

Airline Alliances – How well are they
performing in times of crisis?

Alternative: A New Business Model – what's
the place of the alliances?

Hansjochen Ehmer, Erich Heinrichs

German Aerospace Center,
Transport Division, Cologne

International University of Applied Science
Bad Honnef – Bonn



Overview

1. The current status of airline alliances
2. The actual economic business environment
3. Main reasons for global alliances
4. Alternative models
5. Future developments



The view of the airline versus the view of the air transport policy

Business Administration versus Economics

„To be a partner in one of the global alliances is the most important strategic goal in airline management“

David W. Gillen, Professor of Business, Wilfried Laurier University,
Waterloo, Canada

„The danger of anti-competitive behaviour of global alliances is the most important problem of a liberalised air transport market“

David W. Gillen, Professor of Civil and Environmental Engineering,
University of California, Berkeley



The current status of airline alliances

No generally accepted definition of alliances

World-wide more than 250 alliances

Airline Business, July every year „Alliances Survey“

Loose cooperation (interlining)

intense cooperation (code-sharing)

alliance

strategic alliance (Team LH)

global alliance (Star Alliance)

participation (LH-Eurowings)

integration (LH-Holding)

Concentration on global alliances



Global Alliances

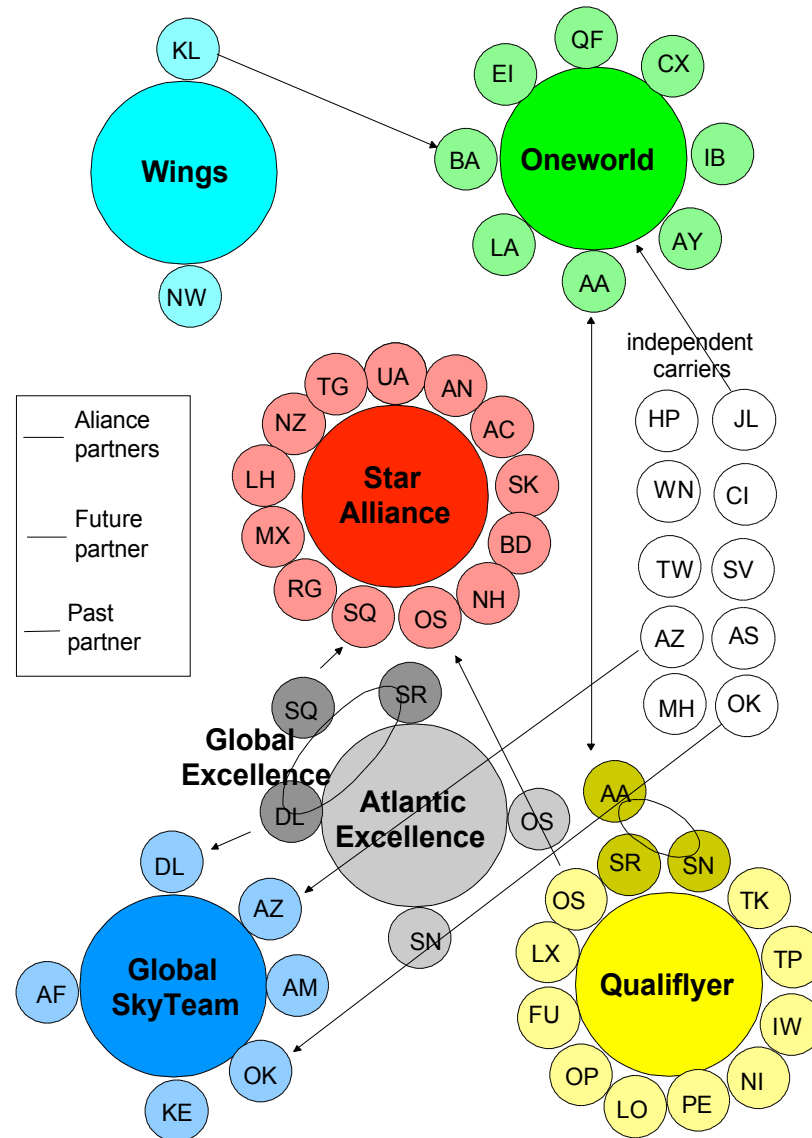
The situation at the end of 2001

Only the official partners

Without code-sharing partners

Further concentration:

- Qualiflyer ended mid 2002
- Members of Wings connecting to Global Sky Team





STAR ALLIANCE

- Air Canada
- Lufthansa
- SAS Scandinavia
- Thai Airways
- United Airlines
- Varig Brasil
- Air New Zealand
- ANA All Nippon Airways
- Austrian Airlines
- Lauda Air
- Tyrolean Airways
- Singapore Airlines
- British Midland
- Mexicana
- Asiana Airlines
- LOT Polish Airlines
- Spanair

Global Airline Alliances II



- AEROMEXICO
- AIR FRANCE
- Alitalia
- CSA CHINA SOUTHERN AIRLINES
- Delta
- KOREAN AIR



- Aer Lingus
- American Airlines
- BRITISH AIRWAYS
- CATHAY PACIFIC
- FINNAIR
- IBERIA
- LANCHILE
- QANTAS



- KLM Royal Dutch Airlines
- Northwest Airlines

Affiliates:

- Alaska Airlines
- Air Alps
- Continental Airlines
- Copa
- Garuda
- Indonesia
- Hawaiian Air
- Kenya Airways

Presentatio



The actual economic business environment

The last ten years

Brief macroeconomic overview:

1991 – 2000 the longest ever upturn business cycle

In the long run the growth rate of the GDP is half of the growth rate of the performance of the aviation industry.

What should be the expected development of the airlines?

Growing demand

→ increase of load factor

→ higher average yield

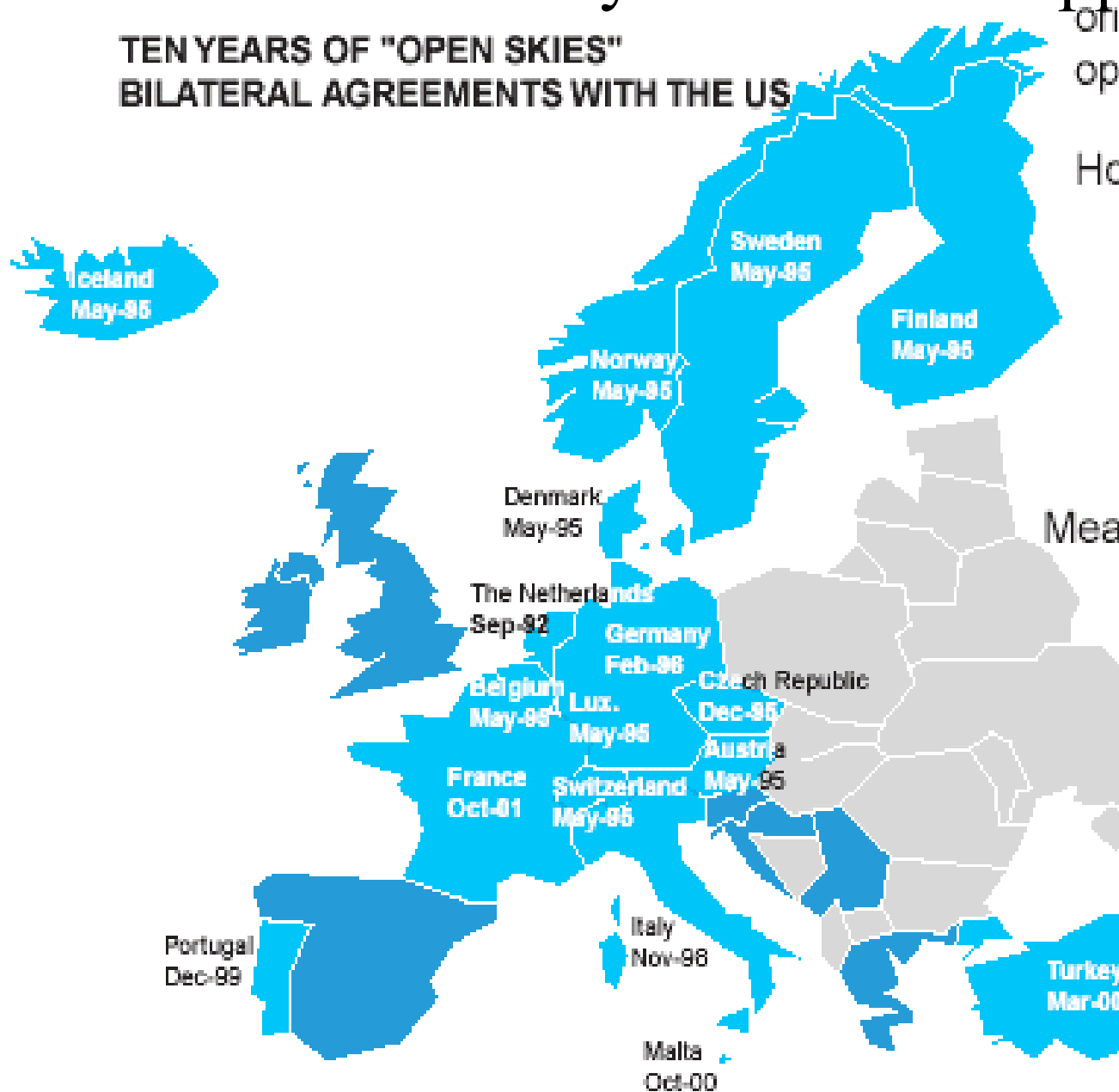
→ higher profits

→ higher reserves



The last ten years – what happened?

TEN YEARS OF "OPEN SKIES"
BILATERAL AGREEMENTS WITH THE US



orig
ope
Ho

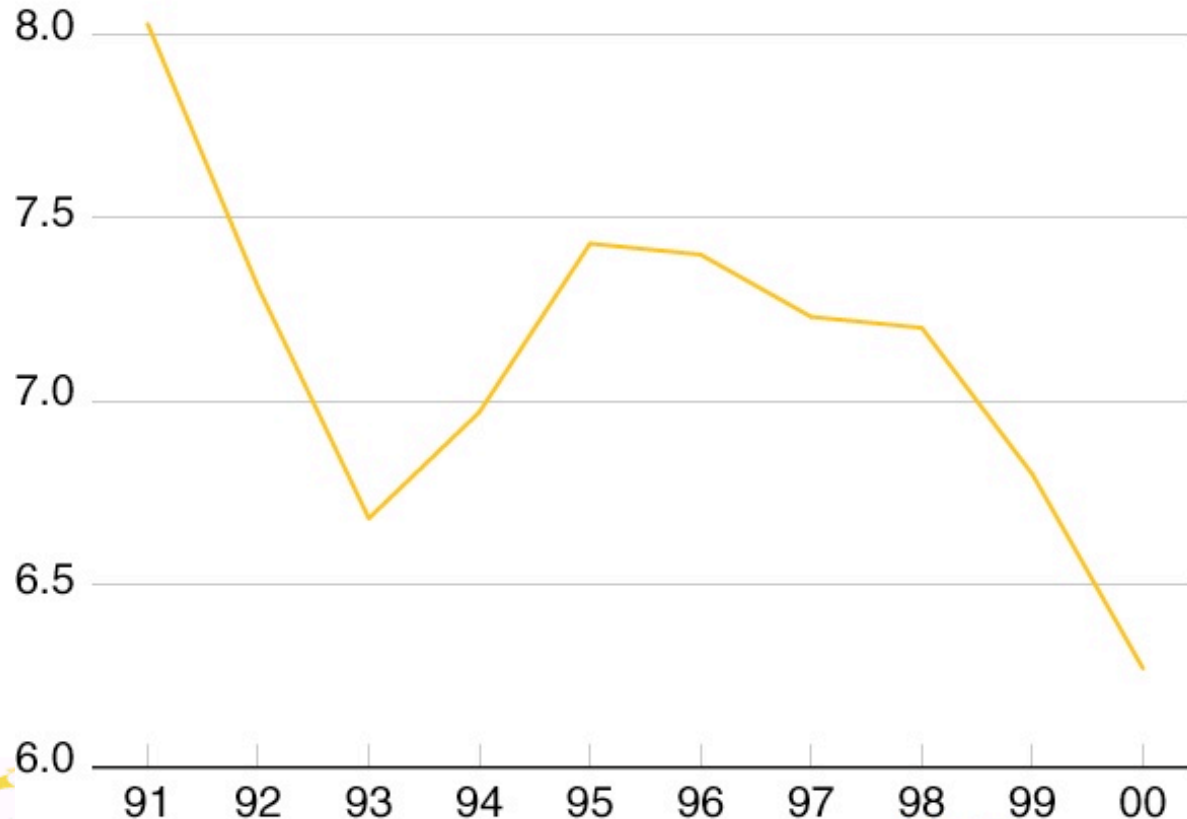
This is the base of
the global alliances

Mediterranean

The last ten years – what happened next?

NORTH ATLANTIC YIELDS

8.5 current USc per passenger kilometre



Concentration through the alliances

However: More competition!

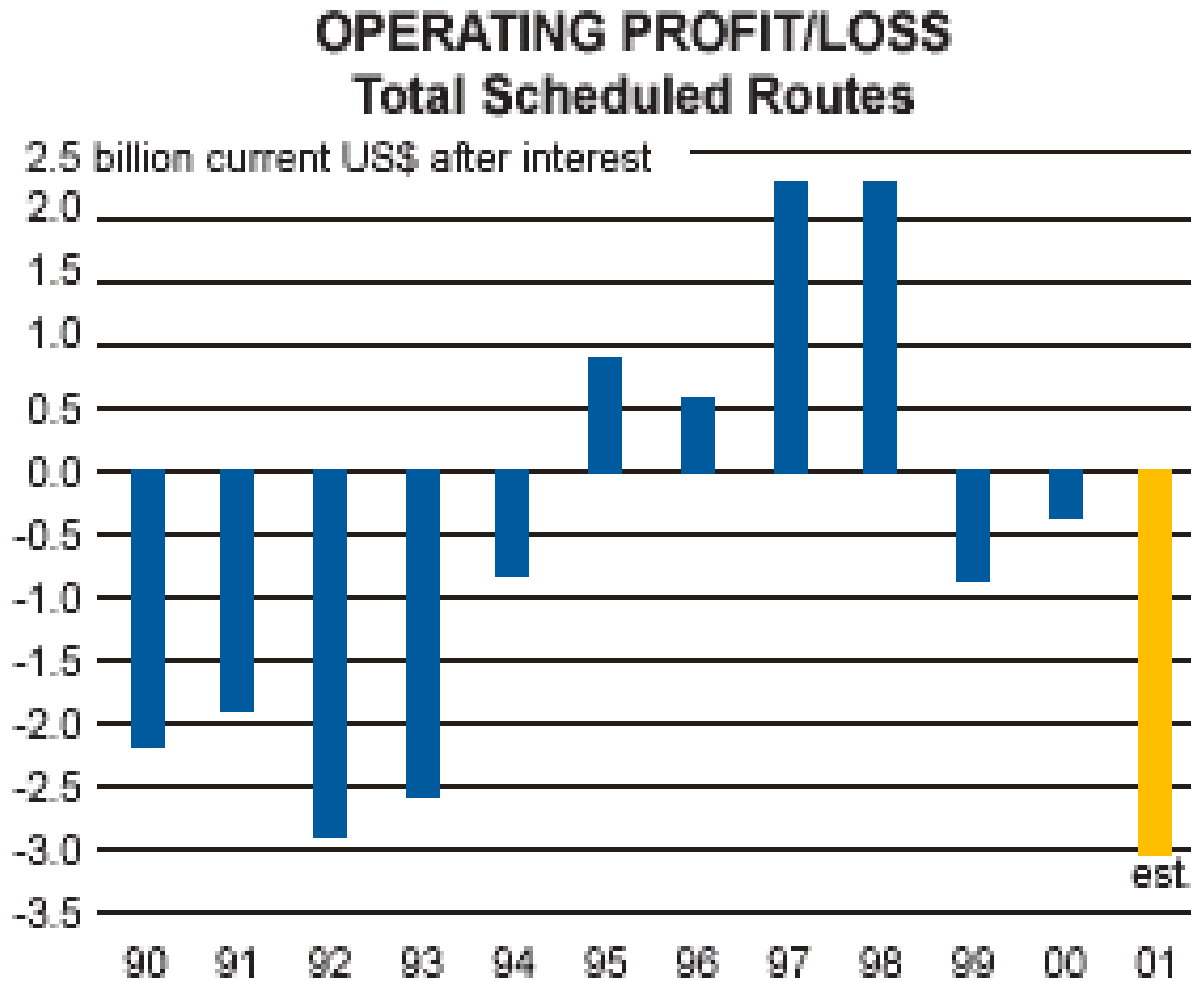
From a polypoly to an oligopoly market

Market share more important than yield

Further concentration?

... and next?

AT A GLANCE



The average rate of return of the airlines over the years below the interest rate

Microeconomics:

If the revenue is below total costs including the normal rate of return

→ disinvest!



The state of the economy

Economic influences

Downturn of the economy starting in 2001

Overcapacity in the airline industry
partially because of the „Schweinezyklus“ in
investments

Decrease of the growth rate of demand of passengers
and of freight



External influences

Directly attacking the airline industry: 11th September 01

leading to the Iraq crisis and finally to the Iraq war

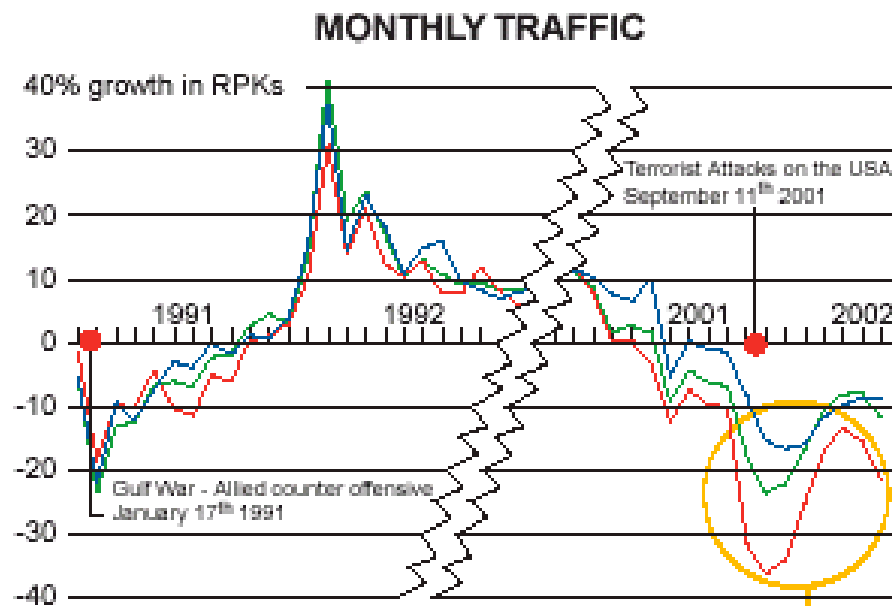
Indirectly attacking the airlines: SARS

Multiplier effect: these 3 influences are not only reducing the demand of the airlines, but also reducing the growth of the economy (economic costs of SARS in the region: 20 Mrd €)

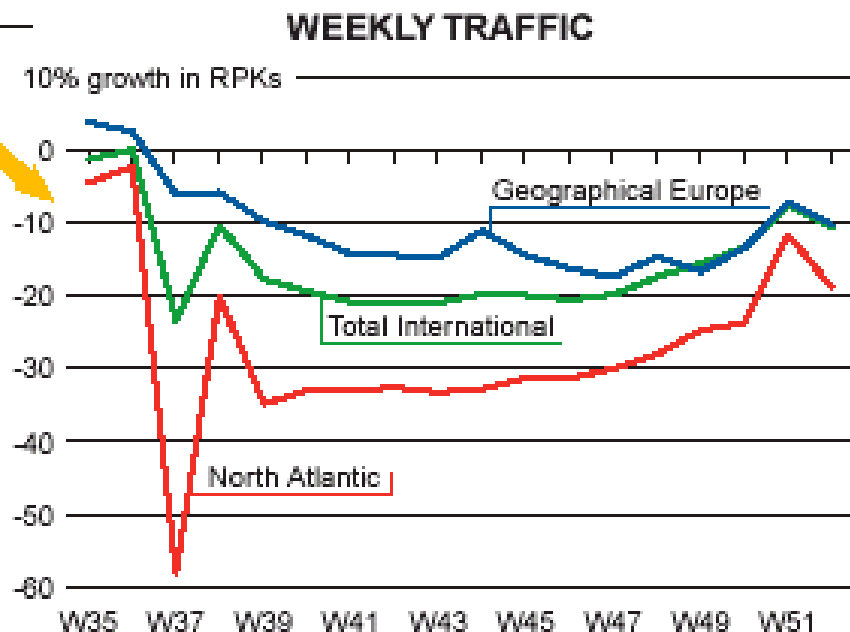
→ new reduction of demand



Demand reactions of these influences



The slump in demand which followed September 11th was dramatic. The immediate traffic loss was comparable to the aftermath of the Gulf War in 1991 but the subsequent depression has been much more prolonged.



Reactions of the airlines

Growing number of airlines flying under Chapter 11

Growing pressure for state aid

(Is it a state aid when the „use-it-or-loose-it-rule“ isn't applied?)

Short-time work and massive dismissals

Suspension of parts of the fleet

(Is it correct that this concerns relatively more the cooperating partners than the network carrier itself?)

(Reduction of supply higher than reduction of demand!)



Some figures

IATA speaks of the „most difficult time in history“
the airlines of „battle for survival“

ACI-figures: because of Iraq and SARS march '03

passenger volume world-wide	- 4.6 %
pax volume Middle East	- 22.2 %
pax volume Far East	- 7.4 %

AEA-fig.: the worst week from 17th March

	17 th March	2 nd June
passenger volume world-wide	- 7.3 %	- 5.9 %
pax volume Middle East	- 36.3 %	+ 3.2 %
pax volume Far East	- 17.4 %	- 27.8 %
by end of April world-wide	- 0.3 %	1-5/03: - 2.6 %

The percentage of fleet reduction often bigger than that of paxes

LH weekly losses of 50 – 55 Mio €,

ANA expects 180 Mio € because of SARS

Presentation June 27, 2003, Bremen H. 15

Ehmer



The competitive situation of the airline industry

Movement from 5 to 3 global alliances

The old **business model** under attack

The old business model consists of **3 airline types**:
network carriers, holiday carriers, regional carriers
with nicely separated markets

Contested by the emergence of the **LCC**

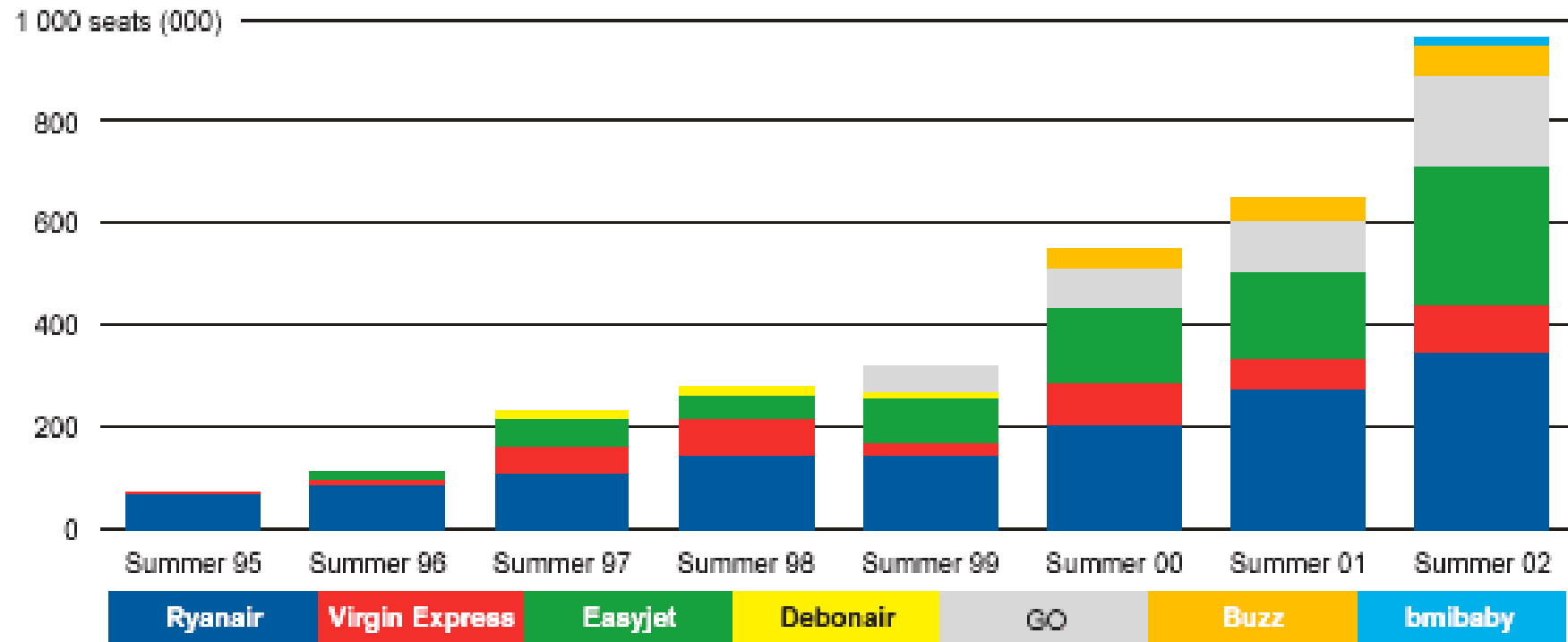
The LCC are the only profitable airlines!

Average ticket price:	Ryanair	49 €
	EasyJet	83 €
	Germanwings	131 €
	Lufthansa	268 €



Development of the LCC and reactions

"NO-FRILLS" CARRIERS' WEEKLY SEATS



Source: OAG

How do they influence the network carriers?

- reduce costs or size down! (M. Klenk)
- breaking up the holding?
- concentration of the network → what's the core business?



Main reasons for alliances

Roland Berger:

The integration of Lauda Air and Tyrolean Airways into the AUA Holding gives synergies of 1 b öS (72 Mio €)

Two thirds reduction of costs leads to one third plus in revenues

Jürgen Weber: „90 % of synergies emerge on the revenue side“

Handelsblatt 28-11-2000

The goal: to bind the high yield customer to the own brand

The main instrument: the FFPs + TACOs (principal agent problem)



Future developments

Growing integration within the alliances:

not only CS and common lounges, but

common purchasing; IT integration; common branding
→ virtual airline

Increasing the scale of the alliance on global and regional level

to fill the gap on a global scale (e.g. China)

to increase the regional penetration

But:

downsizing the business via

- outsourcing as much as possible esp. franchising
- concentration of the whole network on the hubs



What to do with overcapacity?

Concentration as a possible solution

Market concentration is often demanded – what is meant?

Concentration in form of mergers or acquisitions (if allowed) doesn't help very much (Daimler-Chrysler-effect)

Concentration through market exits → prestige factors
e.g. the European experience with Swiss and SN Brussels

When will it really start?

Concentration through integration or close cooperation

The further the **integration** gets within an alliance, the more dangerous will be the bankruptcy of one of its members

The bigger a firm is, the more interest from the government that it stays in the market → **Holzmann-effect**



A future business model

Resumée

Network carriers may concentrate on intercont routes within the alliances

Feeder services will be outsourced, especially to regional airlines

Regional carriers will continue with feeder services and direct hub-by-pass services

LCC will take over more and more continental routes
see the Southwest effect on their new routes

Holiday carriers have to find their niches

First steps to this already in GB, partially in the States



Market monitoring

The concentration effect cannot be hindered

So market power becomes more relevant

In itself market power isn't bad, but its abuse

In markets with growing concentration

→ increase the competitive influence

→ put regulation on a higher level

→ regulate ASAs on EU instead of national level

Close cooperation of competition authorities is needed with
the possibility of penalty (if not, worthless)

Special investigations of market entry / exit barriers



Thank you for your attention !

