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AIRLINE ALLIANCES

MUCH TO BE GAINED, BUT RISKS ABOUND

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OVERVIEW

- Airline alliances take many forms and provide varying benefits and risks to participating air carriers, as well as other stakeholders such as passengers, communities, travel agencies and employees.
- Domestic airline alliances, such as the one proposed by Delta Air Lines (DL), Continental Airlines (CO) and Northwest Airlines (NW), which is currently being reviewed by the U.S. Department of Transportation (DOT), potentially pose multiple benefits and risks for airlines and the traveling public.
- Because of the uncertainty a potential DL/CO/NW alliance interjects into the marketplace, a number of questions need to be addressed before it is approved by regulators and allowed to mature into a quasi-merger.
- Regulators need to examine the impact that an alliance between three of the financially strongest major U.S airlines would have on competition. Put another way, regulators should consider if it is sound public policy to allow unprecedented levels of cooperation by three major carriers (DL/CO/NW) that control nearly 40 percent of domestic capacity?

A DL/CO/NW ALLIANCE RAISES SIGNIFICANT QUESTIONS

There is little doubt that concentration in the airline industry could lead to significantly deleterious effects on smaller, low-fare, point-to-point carriers, consumers in general, and communities in the broadest sense. In this regard, some very serious questions need to be addressed before the DL/CO/NW alliance is allowed to move forward.

1. Will hub-to-hub connectivity between alliance partners result in reduced competition, notwithstanding the Justice Department's prohibition against code sharing by partners in these markets? For example, given the existing relationship between Northwest and Continental, is there real competition between Detroit and Houston?
2. Will service to existing small communities be measurably enhanced by the resulting strengthening of hubs?
3. Does the enhanced service quality offset what might be higher airfares in selected code share markets?
4. Will the specter of three mega-networks in the United States, American, DL/CO/NW and United-US Airways, with a cumulate market share of roughly 80%, lead to excessive concentration?

AIRLINE ALLIANCES

5. Will approval of the current United-US Airways agreement, as well as the pending DL/CO/NW agreement lead to a restructured North Atlantic alliance situation, with antitrust immunity granted for an expanded SkyTeam alliance that is composed of Delta, Air France, Alitalia, KLM, Continental and Northwest?

Each of these issues, among others, should be examined in some depth before conclusions can be drawn as to whether the benefits of the pending DL/CO/NW alliance outweigh the costs. In particular, it has often been demonstrated that the fewer carriers in a city-pair market, the higher the airfares. Approval of the domestic DL/CO/NW alliance could well lead in that direction.

Today's market is sufficiently fragmented so as to ensure a reasonable degree of competition, particularly in non hub-to-hub markets. On the other hand, each decrement of competition threatens that competitive equilibrium.

While DL, CO and NW argue their proposed alliance is a competitive response to the United-US Airways agreement, there is little doubt that the former could be much more formidable in terms of limiting market competition.

The most significant concern with alliances is concentration. If the DL/CO/NW alliance (with Alaska Airlines, which already has a code share agreement in place with Northwest) is allowed to proceed, then the U.S. market structure for the major carriers, which comprise over 91% of the total domestic capacity, can be summarized as:

<u>Carrier</u>	<u>Capacity (seat share)</u>
American	21.9%
Delta/Continental/Northwest/Alaska	37.9%
United/US Airways	26.3%
Other	13.9%
Total Majors	100.0%

In effect, three "systems" would control 86.1% of the capacity of the major carriers and approximately 77% of the entirety of seats offered in the U.S. domestic market. Consequently, there is good reason for both the Justice and Transportation Departments to carefully examine where these joint venture alliances are headed.

AIRLINE ALLIANCES

THE FINANCIAL STRENGTH AND GROWING NETWORKS OF DL/CO/NW DESERVE SCRUTINY

The financial health of Delta, Continental and Northwest relative to their closest domestic competitors, has been covered extensively by the media, as evidenced by the following excerpts:

- “[Delta] had \$2.8 billion in cash at the end of June, giving it one of the best balance sheets in the industry.” (*The Syracuse Post-Standard*, September 2, 2002)
- “Continental said it would have made money if it weren’t for burdensome security costs, taxes and other government restrictions.” (*The Houston Chronicle*, October 18, 2002)
- “Northwest currently sits with nearly \$3 billion in cash reserves, the highest among the air carriers.” (*The Detroit News*, September 11, 2002)

Recent Q3 2002 earnings announcements by Delta, Continental and Northwest provide additional evidence that their financial position is stronger relative to their major U.S. competitors. In fact the *combined* Q3 2002 losses of DL, CO and NW (\$409 million) are less than one-half the reported losses of United (\$889 million) or American (\$924 million).

DL, CO and NW have all recently announced new or enhanced service to domestic destinations. Many of these new flights appear to be strikes aimed squarely at winning greater market share from financially weaker competitors who are not in a position to respond.

For example, *USA Today*, in a recent story titled “Competitors add flights in US Airways’ territory,” noted that Delta is launching nonstop flights from Washington Reagan National Airport to eight new cities this month. The airline’s aggressive expansion on the East Coast seems to be working, as *USA Today* (November 5, 2002) recently noted that Fred Reid, Delta president, “told analysts last month that Delta gained 4 percent of US Airways’ customers on the Northeast shuttle the prior three months” (*USA Today*, November 5, 2002).

A recent quote from Continental Chairman Gordon Bethune voices a likely motive behind these new route announcements. According to the *Associated Press* (October 17, 2002), in comments to analysts Bethune said, “Continental could benefit next year if some of its rivals ‘disappear’.”

BACKGROUND – THE RISE AND IMPACT OF INTERNATIONAL ALLIANCES

Historically, alliances have been most evident in international aviation where, as a matter of public policy, the U.S. government has been willing to offer the air carriers of various countries antitrust immunity for transatlantic alliances as a quid-pro-quo for “Open Skies” bilateral air service agreements. It was, and continues to be the view of the United States government--in particularly the DOT-- that the positive benefits flowing from “Open Skies” agreements with its attendant freedom of entry and exit and pricing, more than offset any possible adverse impact that might derive from the concentration created by the alliances.

Each of these international alliances function--in large measure--under grants of antitrust immunity that allow the partners to discuss schedules, fares, and other business matters that would be prohibited, absent the immunity.

AIRLINE ALLIANCES

The DOT, in its October 2000 study TRANSATLANTIC DEREGULATION: The Alliance Network Effect, has evaluated the results of these international alliances and concluded, “As transatlantic deregulation unfolds, competition intensifies and provides consumers enormous price benefits.”

The study continues, “Alliance-based networks are the principal driving force behind transatlantic price reductions and traffic gains. The ‘Alliance Network Effect’ will therefore play a key role in the evolving international aviation economic and competitive environment.”

While there is little doubt about the latter conclusion, there is some doubt about the former given that “Open Skies” was first identified as the driver. It is not clear, nor does the DOT present evidence that the Alliance, rather than “Open Skies,” produces the consumer price gains.

This conclusion was, of course, predicated on the assumption that alliances were very beneficial in light of the fact that they brought deregulation with them.

DOMESTIC ALLIANCES

This takes us to the U.S. domestic market situation where historically there have been code-sharing arrangements between major airlines and commuter or regional carriers. The relatively loose relationship between Continental and Northwest is a form of alliance, but until recently there have been no other significant agreements. Now, with a US Airways-United agreement, followed potentially by DL, CO and NW (with Alaska/Horizon), there are new questions with which to deal.

First, assuming the approval of the latter agreement, 77% of the U.S. capacity (seats) will be controlled by the two U.S. domestic carrier alliances, plus American Airlines. This leaves the remainder for Southwest, jetBlue, ATA, AirTran, Frontier, et.al. *Does this raise the specter of “mega-networks” being able to “muscle” the smaller point-to-point low fare carriers?*

Second, are these alliances just an incremental step on the road to merger? Domestic carriers have been largely blunted by the Justice Department in their efforts to merge. However, code sharing and alliance arrangements tend to create certain economies of scope that, at least in part, create some of the network leverage of mergers. *Thus, the question is, “Is this the camel’s nose under the tent?”*

Third, since domestic alliances are largely zero sum games, *is the current movement by Delta, Northwest, and Continental a largely defensive move designed to protect the traffic that would otherwise have moved from their networks (and American’s) to United-US Airways? Or is it something else?*

Fourth, *will there be a demonstrative consumer benefit in terms of better service to smaller communities and/or lower fares?*

Fifth, it has been demonstrated that fewer competitive carriers in any given market will lead to higher airfares. *Clearly, shrinking the current reasonably competitive environment to one where two alliance networks and American control 77% of the capacity has to be considered worrisome, and therefore subject to intense scrutiny.*

Lastly having allowed the United-US Airways alliance to proceed with conditions, is it axiomatic that the Department of Justice and DOT will do the same with Delta, Northwest, and Continental?

AIRLINE ALLIANCES

Clearly there is some sympathy for the plight of the industry, and therefore any move to strengthen the financial posture of the carriers is likely to be generally well received. On the other hand, a number of issues have been raised by the smaller carriers--some of which merit consideration.

In a 1999 study of Aviation Competition by the General Accounting Office (GAO RCED-99-37), Effects on Consumers From Domestic Airline Alliances Vary, the GAO concluded:

"The alliances may have both beneficial and harmful effects on consumers. And because they differ in scope, their possible effects vary." The study continues, "Our analysis showed that the alliance could result in new, possibly improved, route options, and the alliance's extended frequent flyer program may benefit members of each airline's program. We also found that this alliance will create some "new" markets that are not already served....However, our analysis indicated fewer new markets than the alliance partners estimated..."

Finally, "On the other hand, consumers would be harmed if competition is reduced. But it is difficult to determine whether the partners in the alliance will continue to compete or whether the alliance will encourage them to act in a manner that may reduce competition."

The risks perceived by the GAO study are that the cumulative benefits to the consumer in terms of improved services to smaller cities, increased frequent flyer flexibility and awards, lounge facilities, and online services, could be more than offset by the potential tendency for reduced competition, which leads to reduced service levels, increased pressure on smaller, point-to-point carriers, and ultimately higher fares. In fact, when the GAO interviewed a number of industry experts, they found, "These experts maintained that such an alliance would likely harm consumers by reducing competition between the two airlines, eventually leading to higher fares. Over time, airlines in this type of alliance would jointly identify the markets where it would make financial sense for them to reduce or eliminate capacity, especially those markets where the partner airline had more flights."

In today's environment, for example, there are fourteen daily non-stop flights between Atlanta and Houston Intercontinental, eight of which are operated by Delta, and the remaining six of which are operated by Continental, but with NW codes on each of those six. Arguably, there is at a minimum, competition between Delta and the Continental-Northwest partnership. However, once the alliance is in place, how vigorous will the competition be? Particularly if load factors fall and there are signs of excess capacity in the system, as there are today. And, how will this impact schedule quality and pricing?

Looking at some recent data, we found mixed results in the context of the Continental-Northwest alliance. Between 1998 and 2001 average yields (price paid by the passenger on a per mile basis) in all U.S. domestic service fell by 4.8%, while average yields between Detroit (NW), Newark and Houston (CO) combined, increased by 27.5%. At the same time, average yields between Minneapolis (NW) and Newark and Houston (CO) combined dropped by 7.9%.

Of considerable interest is the fact that the GAO report examined potential alliances between American and US Airways, Delta and United, and Continental and Northwest, a somewhat different configuration than we see today. Today's changed scenarios suggest that domestic alliances may be measurably less stable than international alliances. On the other hand, stability could be encouraged by today's extremely difficult financial environment.

AIRLINE ALLIANCES

CONCLUSIONS

There are many benefits to be derived for the traveling public as a result of domestic alliances. Consumers may see some modest improvements in service to smaller communities resulting from hub synergies, improved frequently flyer programs, better lounge access, and more online options for travel.

On the other hand, there are also serious dangers if the ultimate outcome is an oligopoly that leads to reduced service quality and higher prices. In part, the latter could evolve as a result of the increased network power that could well endanger the long term viability of all but a few of the low fare point-to-point carriers.

Regulators need to examine if it is good public policy to allow three of the strongest U.S. major carriers to form a domestic alliance. While Delta, Continental and Northwest cite the need for cooperation to protect their market share in a radically changed business environment, this hypothesis needs to be carefully tested by regulators.

The question is, "Do the benefits outweigh the costs?" At a minimum, the question needs more thorough study by regulators before a conclusion can be drawn on a set of transactions that could lead to a substantially reduced level of competition and subsequent higher fares for consumers.

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For more information on these and other issues, please go to our newly updated website: www.ga2online.com

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