

Future Developments in the Structure of Airline Alliance Networks

a report by

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Co-operation between airlines is not new, but, whereas the types of alliances that were forged in the 1980s were mostly technically oriented (maintenance pools and co-operations such as KSSU and ATLAS), today's alliances are oriented more towards marketing. There seem to be five main reasons why airlines seek to co-operate with each other:

1. Customer expectations – the requirements of the travelling public go towards 'seamless' travel to a maximum number of points across the globe, and this goes beyond what any single airline could provide.
2. Defence – defensive grounds can be active, as a forward defence by consolidating one's position through traffic feed from an allied partner, or passive, for example, by sheltering from competition.
3. Control of the environment – a single airline has, to some extent, influence over its immediate task environment, but relatively less leverage over the larger general environment. The alliance, if acting as a representative of its members, is likely to have more negotiating power *vis-à-vis* external suppliers or (possibly in the future) regulators.
4. Economies of density – these occur when unit costs go down as the volume provided increases at a fixed network size. One can distinguish between link density, which is related to the load-factors on a flight or city pair, and network density, which measures the efficiency of fleet utilisation over the entire network or a set of routes.
5. Economies of scope – these occur when unit costs go down as multiple products are produced. In airline terminology, they can also be called 'economies of network size'. Alliances offer an airline the opportunity to reap economies of network size even though they do not physically expand the number of points they serve themselves. Possible sources of these economies are codeshares, a broadening of the marketing presence through joint branding, and access to well-distributed frequent flyer programmes.

When considering the dynamics of alliance networks, one must keep in mind that airlines differ significantly in the nature and scope of services provided, and also in their expectations from, and contributions to, an alliance. The objectives listed above each have a different weight for different carriers.

One way of classifying airline types with different needs is grouping them according to their network characteristics:

- Local champions – short to medium-haul airlines, based around one or two main hubs and possibly several secondary hubs within their respective home region. They do operate limited long-haul services and some of these intercontinental operations – for example, Finnair's routes to Asia – are high-yield and generate significant revenue, but these often constitute a relatively small part of overall operations.

Some are true niche carriers in that they serve markets where they enjoy a high presence and relatively little competition. Some of these markets can be quite attractive due to their wealth (for example, Northern Europe).

Characteristically, the local champion type of carrier concentrates on serving its own world.

- Long-haul operators – intercontinental flights constitute a fairly high proportion of their total flight operations and revenues. Some of these airlines are in this category due to the geopolitically 'remote' location of their home, such as Australia/New Zealand or South America. As flag carriers, their mission was to link their country to the rest of the world. They typically connect their home market, where they enjoy a dominant or close to dominant position, with the respective important business centres on other continents.
- Transcontinental connectors – these airlines aim to serve the whole world; they operate to several continents and have the capability to link two



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continents through their home hub on a third. For example, American Airlines links Europe with South American points through their hub in Miami, North American and African destinations are linked through hubs in Europe, and several Asian carriers link Europe to Australia. They also often operate dense local networks, but these do not necessarily constitute their primary *raison d'être*. The role of a transcontinental connector requires a centrally located homebase, such as in Europe, North America or a central location in Asia. Most transcontinental connectors also have local champion operations.

It is possible to make out two broad degrees of interaction between two or more alliance partners:

1. Low-density alliances based on exchange – contributions and outcome are intended to be proportional. The participator's orientation is primarily towards its own goals; co-operation is limited to certain routes.
2. High-density alliances based on integration – these alliances display a more collective orientation. The focal unit is the overall alliance route network and the way services on it are sold, not an individual city-pair. Integration-based

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Looking at the types of airlines grouped in an alliance, it can be seen that the most homogeneous alliance is STAR, whose members remain in the cluster of globally and, from three continents, transcontinentally operating airlines (with the exception of SAS, which instead contributes access to the high-yield, but somewhat peripherally located, Northern European market).

In the future, however, we can expect a tendency for alliances to become more heterogeneous. Each intercontinental carrier already has a subsidiary or affiliated airline serving as a local feeder. Within STAR, the plan of devising a scheme for 'second-tier-membership' to accommodate these local contributors into their 'seamless service' concept has already been discussed, and Mexicana is said to become the first 'Starlet'.

Classifying Alliances According to the Degree of Integration

A considerable part of the future structure of alliances can be explained by measuring the tightness of coupling between members. The higher the degree of interaction, the more the alliance membership is likely to influence the member airline's internal structure. Links between airlines are of different quality, ranging from mere route-by-route co-operation over marketing agreements and joint Frequent Flyer programme recognition up to equity investments and seats on each other's boards to a joint governance body.

alliances feature increased interdependence between members. A tightly integrated alliance can, in a way, be considered as an organisation in its own right, both to the outside environment and towards its constituting members. At high integration levels the member airlines will move towards constituting organisational units of the alliance, rather than being independent contributors to it. It is also here that we are likely to witness a slowing down in the rapidity with which alliances are tied and dissolved.

Another interesting aspect in the future morphology of alliances, which is related to integration, is that of exclusiveness of a network. An example for this is the recent cancellation of a codesharing agreement between Varig and Japan Airlines. A codeshare on the 'long-thin' routes between Brazil and Japan might have made business sense, but it could not be upheld due to Varig's membership in the STAR alliance, which comprises an exclusivity clause.

Niche Strategies as an Alternative to Alliance Membership

There is a non-negligible domino effect in alliancing: if all other airlines with whom a carrier competes are allied, and thus offer their customers a much larger network, the entire competitive environment has shifted so much that the non-allied carrier, who now competes against the might of an alliance, is forced to adapt to it by joining an alliance himself, if he wants

to survive. The only apparent alternative would be to retrench and concentrate on dominating a niche market. If the chosen niche is based on geographical specialisation, it would not be a completely safe haven from competition, for it would be challenged – and possibly lost – as soon as a sufficiently competent intruder tried to connect the niche region to the outside world. This is because the connector can, courtesy of his network membership, bring new customer bases to that niche market. Dominating a geographical niche is thus not a reason for avoiding an alliance, but rather a reason to enter one, for it will translate into being a ‘local champion’, who contributes his market dominance to the alliance and in turn reaps benefits of increased marketing scope.

The other niche strategy, one which appears to be impervious to at least the current alliance movement, is that of functional differentiation, for example, that of low-fare, no-frills services, and we currently see no low-fare carrier participating in the big alliance game. One straightforward reason for this is the need for a more or less homogeneous fare structure as well as a requirement for similar service levels across alliance partners. It would be possible to imagine the formation of alliances between the low-cost carriers themselves, and this is in fact likely to happen at some point. But the concept of low fare operations is, in itself, still fairly immature, and different airlines still experiment with various low-fare strategies.

Lastly, there is not yet the perceived need for a network between low-fare carriers. The reason lies again in what passengers have come to expect from the relatively new dimension of cheap no-frills travel. Low-cost airlines concentrate on point-to-point services (often to secondary airports), many operate very simple reservation systems and passengers do not, at the moment, expect anything else. Thus, neither the passenger expectation factor nor the domino effect of having to react to alliances being formed within one’s environment have come to influence the low-fare niche universe so far.

A Possible Alliance Scenario for the Near Future

What we can currently observe is that there is a wide variance in airlines’ willingness or ability to enter different levels of integration, and that these differences in tightness of links are likely to define the structure of airline alliance groups as they approach maturity.

An airline alliance is likely to become a network with different levels of integration between its members. It is possible to distinguish at least three positions within an alliance. At the heart of the

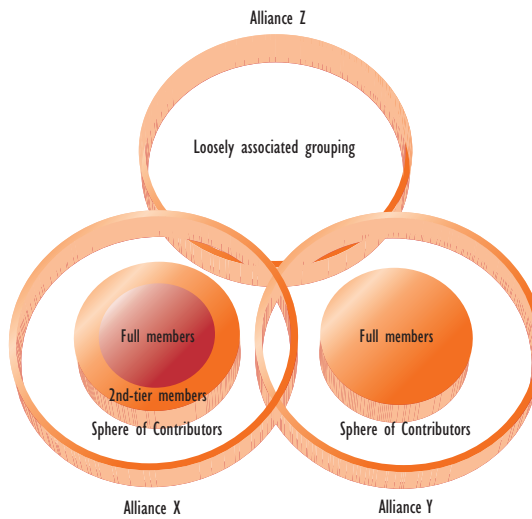


Figure 1: Types of Alliances

alliance, a small number of partners (‘full members’) co-operates tightly, possibly even relinquishing some authority to a joint steering board. The agreements between these full members are likely to be fully multilateral and exclusive, as is already the case with the STAR alliance.

The full members are supported by the ‘second-tier members’. These are typically affiliated feeders which collaborate more tightly with one of the full members (possibly also due to equity ties) than with the others. The distinction between full members and second-tiers is hierarchical: second-tier members

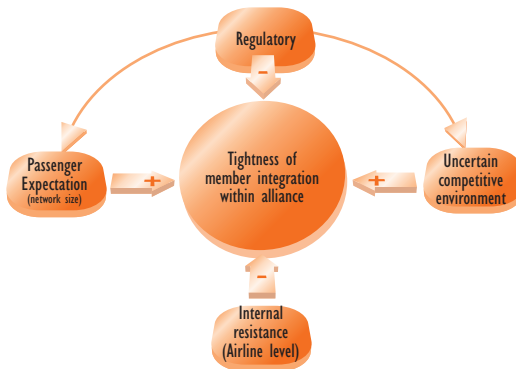


Figure 2: Forces which Determine Alliance Members’ Integration Levels

do not have the same power within the alliance, but they receive density and scope benefits.

Lastly, there is the ‘sphere of contributors’, which consists of airlines which co-operate with the alliance on a route-by-route basis. Contributors can co-operate with airlines from different alliances. They seek co-operation based purely on single codeshares. Some of these contributors might be long-haul operators from relatively remote locations which seek optimal connections between their home hub and a small number of points on other continents, or

they might be small regional operators which are contracted by one of the allied carriers to serve a specific route for them.

Different alliance groupings will form along these lines, but there will be a variance in types of alliances as well. Some alliance groups will be merely loose networks (“Alliance Z” in *Figure 1*) while others will be quite hierarchical with a densely integrated core (“Alliance X”), or some hybrid form (“Alliance Y”).

Drivers of Alliance Structure

All three alliance types are structurally distinguished by the different levels of interconnectedness, or tightness of coupling, between their members. It seems that there are four prominent factors determining the differences in tightness of coupling, namely: regulation; passenger expectations; the uncertain competitive environment; and internal (managerial) resistance. This can be depicted as follows:

The two factors which positively influence the tightness of co-operation between alliance members are, as discussed above, passenger expectations of a

travel. Moreover, the mere fact that strong regulatory forces govern air transport is inducing airlines to co-operate with each other in order to maximise their influence on regulators. A further factor increasing the need for environmental control is that uncertainty levels and competitive pressure on airlines increase due to the gradual reduction of traffic regulation: as fifth, sixth and seventh freedom rights become more common, there are more possible competitors which can access markets.

Conclusions

The question for airlines during the coming years will be not so much whether or not to join an alliance network but, rather, to what extent they can and should integrate themselves in such a network.

An alliance member airline’s hierarchical position within the alliance will depend on its degree of integration and on its scope. The managerial implications at the level of the individual airline are twofold:

1. In order to secure an optimal position within an alliance network, an airline should seek to clearly

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seamless network and the increased uncertainty of operating in a deregulated environment.

The next two factors work against tight co-operation between partner carriers. Within airline management there is a large reluctance to give up independence and to relegate decision-making to some entity outside the company. Even though they might consciously favour an alliance membership, managers are likely to put their own airline’s interests above those of the alliance, thereby working against integration.

Lastly, it is interesting to note the impact of the regulatory environment. On one hand, there is a strong resistance to approving alliances which would dominate a certain market or a certain hub airport. This has a negative effect on the tightness of member coupling, as it can prevent codeshares and joint pricing. But regulation also has an impact on customer expectations as well as on the airlines’ requirements for environmental control. As discussed, the opening of markets has changed what customers expect from air

place itself either in a global connector or in a local champion role. The key is clear dominance of a certain market.

2. However, since it is not yet very clear what degree of interaction and integration the regulation authorities will allow, airline management should be wary of giving up too much independence too fast. Making concessions to an alliance only makes sense if they are to be operating in tight co-operation with partners, and within a long-term time framework.

In these early days of alliance formation, airlines must strengthen their core, but should simultaneously maintain non-core markets in order to remain independent – for the time being. There may not be an imperative need for participating the current ‘alliance frenzy’, where many an airline rushes into agreements for fear of being left out of alliances. The final form of airline alliances has not yet been defined, and a cautious approach to alliancing might be recommendable. ■