There are several claimed advantages and benefits of code-sharing. Jim Smith examines some airline code-share arrangements and the benefits they have brought their partners, as well as taking an insight into other partnerships which have not worked out.

The benefits of code-sharing

On 20th November 1999 fifth-largest US carrier Continental Airlines announced that an affiliate of fourth-largest US carrier Northwest Airlines had completed its acquisition of a controlling stake in Continental.

The deal translated into the purchase of a 13% ownership stake and 46% voting rights in Continental for $370 million plus 2.6 million shares of the affiliates own stock.

The agreement also contained voting restrictions connected with the acquisition. After changes made to satisfy competition concerns of the US Departments of Justice and Transportation (DoT), the deal was given the US government's imprimatur on 4th December.

With the stroke of a pen, the alliance between the two carriers created a fourth major US airline network competitive with the big three US-based airlines; Delta, American and United. The new alliance was not a full merger, in that while the airlines can sell seats on each other's flights they maintain separate fleets and operations.

The transaction was an unusual means to reach a code-sharing agreement, but straightaway allowed the two to partner on about 850 domestic and international flights to 95 destinations.

Having few suitors is the ominous other side of the equation. In spite of a mega-order in mid-December from Trans World Airlines (TWA)-its biggest order ever-including firm commitments and options for up to 250 Airbus and Boeing aircraft-the US carrier has not been a courted partner.

For the full year ended 31st December 1998, TWA reported an operating loss of $65.2 million. In fact, TWA has code-sharing agreements with Royal Air Maroc and Royal Jordanian, plus a just-completed agreement with Kuwait Airways. In spite of the imminent deliveries and these code-shares, TWA's losses appear to be deterring major carriers from seeking a formal relationship.

Code-share examples

Partnerships take on various forms. Past failures range from small, space-sharing arrangements-such as an ill-fated link between American and Cathay Pacific, the disintegrated British Airways (BA)-United partnership which was to have featured the UK partner buying into United, and the subsequent failed BA-US Airways venture.

An example of the successful is the Northwest-KLM mother-of-all-alliances, which was given full anti-trust immunity by the US government in 1992.

In between, there have been a slew of alliances involving Canadian, European and US airlines. Most of the early alliances produced little-if any-tangible results.

In a very recent "alliance", Chilean national flag carrier and Oneworld alliance member Lan Chile Airlines was named general sales agent and representative in the US for new carrier Lan Peru, a Peruvian company in which Lan Chile holds a 49% ownership.

Lan Peru began operations in late June 1999 with service from Lima to Cuzco and Arequipa with two 737-200s. All flights are designed to connect with Lan Chile's Santiago-Los Angeles and -New York operations.

A Lan Chile official said that while the relationship is not a code-share per se, it allows passengers one-stop shopping in extending to destinations not served by the parent and allows for frequent traveller miles to be applied to Lan Chile, American and Canadian Airlines. This is one example of a virtual airline scenario.

With Continental Airlines recently backing out of its decision to buy Aero Peru; Lan Peru, along with Peruvian domestic airline Aerocontinente, which has been proposing an alliance with Aero Peru for several years, and TransAm, which is supported by Salvador's Taca Group, are three carriers which might benefit from the inability of the Peruvian national carrier to re-launch service without a partner.

Creditors of bankrupt Aero Peru have given the airline until 12th July 1999 to come up with a new reorganisation plan.

Continental Airlines on 17th June, after completing due diligence, decided against buying a stake in the debt-ridden carrier, five days before the scheduled re-launch with an infusion of cash from the US airline. Continental was said to have been close to taking a 49% stake in the Peruvian carrier for an estimated $30 million. American also looked at the deal, but declined to buy a stake in the bankrupt carrier earlier this year.

Code-share benefits

Airline officials point to a handful of basic reasons–none of them for the benefits of others–why airlines enter into code-sharing agreements or alliances. Airlines may join with partners to test the waters for a stand-alone entry to a market. Carriers also make pacts to generate revenues by extending their reach into places previously not served–a form of virtual airline-either because of economics or due to a lack of landing and operating rights.

Carriers can also use code-shares to make cost savings and, to a much lesser degree, circumvent prohibitions against

Delta has had many code-share relationships which have not stood the test of time. It has recently formed an alliance with Air France, but some suspect this may affect Delta's relationship with its other European partners; Sabena, Swissair and Austrian.

civil aviation authorities from operating aircraft into more regulated venues. An example is in the US when the Federal Aviation Administration (FAA) locks out aircraft domiciled in countries with unsatisfactory safety ratings.

Code-sharing and airline alliances are widespread and will probably remain a part of the market at least until global "open skies" is realised. At that time, some of the need to team up will be mooted.

Other airline executives point to the downside of code-sharing and alliances, namely clashes of cultures, the uncertain state of European aviation as the EC moves to coalesce into a single entity, and the unwillingness of some Asia Pacific carriers to sign into alliances they cannot control.

At least one airline official noted that carriers consider entering alliances, not because they are beneficial, but out of fear that competitors will forge their own partnerships to siphon away business. Alliances are designed to take traffic away from other carriers rather than develop traffic for member airlines, according to the official.

Another cited downside is that code-sharing alliances can reduce the incentive for airlines to move in on competitors' air routes because the code-sharing airline can reach these destinations without having to fly there itself. While in theory this would buttress the bottom line, it is also perceived as anti-competitive in some circles. Without competition fares go up.

Even in the US domestic market, there are 49 regional carriers in code-sharing alliances with major airlines. Of those, 13 are fully owned by the major airlines; such as American Eagle which is owned by American Airlines parent AMR and ASA which is owned by Delta. Three are partially owned, including Sky West, Comair and Mesaba.

US regional airlines carried 71 million passengers last year; one in nine US passengers flew on a regional carrier. A Regional Airlines Association official maintained that the strategy is to "capture the passenger early in the system". A carrier cannot serve all of the 730 US airports with commercial service. "But its hard to forego any amount of revenue," she added.

Cut-rate carriers in any domestic market usually do not see a need to form code-shares or alliances. Overall revenues for these carriers are a function of low fares and not of any added convenience or value added element. These airlines can retain customers through frequent flyer plans without the need to enter into complicated relationships because the customer base is point-to-point.

Low-fare US-based Southwest Airlines is a textbook example of an airline that has resisted the need to expand beyond its core competency–the domestic point-to-point market–and operates without partnering.

Some benefits

Symbiosis is sometimes fleeting. When United and BA allied with each other in 1988, outsiders thought the symbiotic relationship would last forever. That was not the case. Two years later, when the British government agreed to let United acquire Pan Am's slots at London Heathrow, divorce papers were signed.

The split should have come as no surprise. Airline executives will admit that for any number of reasons–but particularly because it hurts to give up revenue–ultimately airlines would rather go it alone than team up with a partner either domestically or internationally.

Carriers often see alliances as the only way to enter markets otherwise denied them by restrictive bilateral agreements. In fact, because of restricted bilateral agreements which grow out of the Chicago Convention of 1944, carriers often are prevented from providing a desired level of service to major markets. For example, US carriers are restricted in serving Argentina, Brazil and Japan, and can circumvent that problem only through code-sharing agreements.

"Our general perception is that the alliances are more valuable in revenue development than in cost savings. From the cost savings end, carriers can attract passengers to routes which never before hosted basic scheduled service. From a passenger standpoint, fares are the lowest with allied carriers than having passengers dealing with stand-alone carriers for trips which require interlining between aircraft," according to Paul Gretch, director of the Office of International Aviation at the US DoT. This opinion is borne out in a recent United-Ansett code-share. United was losing money on its Los Angeles to Sydney and Brisbane service. The addition of Ansett as a code-share partner turned the route profitable.

Managing director Ray Neidl of investment bank Furman Selz said, "Major airlines throw out a figure of $500 million per year earned from alliances. If that's true, they are taking the money out of one pocket and putting it in another". Niedl said the largest benefit of partnering comes from cost savings in the combining of facilities which is done among alliance partners.

From a passenger standpoint, Neidl said the reduction to four alliances from 11 or 12 independent transatlantic carriers will stabilise pricing and make travelling easier.

Long-term

Gretch added, "Most airline alliances are ongoing although there have been some 'musical chairs.' Carriers are competitively interested in forming alliances". Some carrier relationships

United is a member of one of the largest alliances; the Star Alliance. The alliance has become this successful because it is one of the groups which involves a major Asia Pacific carrier, Thai International.

have reached long-term proportions.

In 1993 Northwest and KLM were the first global alliance to obtain anti-trust immunity and to operate as a single business venture under an open skies agreement between the US and the Netherlands. Gretch noted, "The Northwest-KLM relationship is perceived to be one with the greatest beneficial impact on the bottom line. Our perception is that the Star Alliance has not gone to the closeness of the KLM-Northwest partnership".

Earlier this year, Northwest released the results of a recent study that the carrier says illustrates that the benefits of the Northwest/KLM alliance are as much as $185 million annually in lower ticket prices. The study examines the benefits of international alliances to the travelling public.

Two economists found that interline passengers, who fly on two airlines to make their trip, pay substantially lower fares when the carriers are alliance partners. The interline fares charged by unaffiliated carriers are, on average, 36% higher than the fares charged by alliance partners. Using the Northwest/KLM alliance as a case study, the authors concluded that without the Northwest/-KLM alliance consumers would annually pay between $111 and $185 million more for air travel, with the exact savings a function of price sensitivity of the demand for air travel.

Alliances therefore generate substantial price benefits for interline passengers. They went on to calculate a measure of the benefits to passengers provided by the existence of the Northwest/KLM alliance. If the NW/KLM alliance were terminated, fares would rise substantially in all city-pair markets, and the recent third quarter welfare loss to interline passengers would range between $34 million and $56 million.

Ex-code-shares

What the numbers and the studies do not reflect is that the NW/KLM partnership was a disaster in terms of management styles and cross-equity participation. But the longevity of code-shares and alliances across the spectrum is not borne out by history.

Late last month, British Midland Airways ended a code-sharing agreement with American, effective the end of next March. The agreement will have been in effect for six years when it is terminated. Officials of the UK-based airline maintained that the arrangement no longer made sense because of the increasing number of global airline alliances. The number of passengers taking advantage of the deal-by which the two carriers can book seats on each others' flights on routes from Chicago, Boston, Los Angeles, Miami and New York to London Heathrow-has fallen considerably since inception in November 1993. An airline official said in a prepared statement that, "Over a period of time, the formulation of various airline alliances, including Oneworld, has seen passengers diverted onto other airlines within such groupings".

Oneworld is one of the four main global airline networks and it groups British Airways, American, Cathay Pacific and Spain's Iberia. British Midland still has code-sharing arrangements with three other trans-Atlantic partners–Continental, Virgin Atlantic, and United.

Delta Airlines recently signed a 10-year pact with Air France. Delta said the alliance would include the existing partners of both airlines and may include other carriers. However, in recent years, All Nippon Airways, Singapore Airlines, Brazil's Varig and Virgin Atlantic have each dropped Delta as an alliance partner.

On 16th April, Delta suspended its code-share with Korean Air Lines "in light of operational incidents, including the recent tragic loss of an MD-11 cargo aircraft in China". That arrangement had been in effect since 1995.

Less than two weeks later, Delta announced that its code-share with Aer Lingus would be ended. Delta officials maintained that the relationship was counterproductive since the US carrier had demonstrated its ability to dominate the market without the need for an Irish partner. Delta said that becoming the number one US carrier between the US and Dublin and Shannon reflected the airline's ability to go it alone.

Delta retains ties with Belgian national carrier Sabena, Austrian Airlines and Swissair in the Atlantic Excellence partnership. This alliance is smaller than the Star Alliance anchored by United and Lufthansa Airlines and the Oneworld alliance anchored by American and British Airways.

American Airlines has just had its partnership with British Midland Airways terminated. The British carrier cited the increasing number of airline alliances as the reason for leaving the agreement. American is the US member of the Oneworld alliance, which has BA as its major European partner.

Future relationships

The news that Delta had formed a partnership with Air France was followed by the announcement that Swissair and Sabena-Delta's allies in the Atlantic Excellence group-had entered into code-share agreements with American. This further suggests that partnerships are far from immutable. Membership in most alliances is always subject to change-often at little notice.

The permutations of code-sharing and alliance relationships are limited only by the number of possible airline partnership combinations. Air France officials are said to be looking for the Delta partnership to generate an additional $150 million in profits.

Sources say Delta also is seeking a deal with Colombian carrier Avianca and will begin flying to Argentina next summer and Chile in the summer of 2001. Avianca president Carlos Menem said in late June that the country may sign an open skies aviation agreement with the US before year's end, opening up the South American country to more airlines. Delta still lacks an Asia Pacific Pacific partner in its plans to develop a truly global alliance, and most of the first tier Asia Pacific Pacific carriers are committed to other alliances.

The Air France connection, however, will give Delta access to Europe, Asia Pacific and Africa. Air France's choice of Delta is logical: the US airline ranks first among US passengers and third in US revenues.

Summary

A recent report from Merrill Lynch maintains that "the most important rationale for establishing an alliance is that it allows an airline to increase the geographic size of its network without sizeable capital investment". The report adds that as alliance partners are chosen to fill voids in route networks. Airlines serving the very large markets of India and China, for example, are prime candidates for alliances. These domestic markets are off-limits to foreign carriers, much the same as exists in the domestic airline and shipping and cruise businesses under US cabotage laws. Elsewhere, Delta has been able to circumvent Swiss cabotage laws with the addition of its code-share to Swissair flights between Geneva and Zurich for connections to New York.

The Merrill Lynch report suggests that airlines losing money in key markets should investigate allying to withdrawing from the market. For example, when Delta bought Pan Am's Frankfurt-based Atlantic division in 1991, Delta did not have the same European support network or access to the German domestic market as Pan Am had. Delta subsequently lost $1 billion between 1992 and 1993. Partnering with Austrian, Sabena and Swissair turned the unit profitable even with competition from the United/Lufthansa code-share which began in 1994.

Regulatory, labour and safety issues can be problematic for alliances. Labour generally is not pro-alliance. Liability issues related to transporting another carrier's passengers is a concern, as demonstrated by the 53 Delta co-share passengers who perished in the Swissair MD-11 crash Nova Scotia in September 1998.

Merrill Lynch notes that there are different regulatory hurdles in each region, with US anti-trust laws aimed at protecting consumers from the pitfalls of monopolistic practices, while Europe is supply-oriented. The report points out that anti-trust immunity for a joint venture will only be given by US authorities if the foreign partner's home country has an open skies agreement with the US.

Formation of the European Union (EU) brings another set of problems, most notably an assertion by the EU Competition Commission that individual agreements between the US and individual EU countries are illegal. Open skies should be negotiated between the US and EU as a whole.

The report asserts that the value of global alliance brands, for example, Star Alliance, Wings and Oneworld, will exceed the value of each member airline's brand. The importance of these brands will increase as aviation laws are liberalised. Long-term commitments are necessary precursors to cost-cutting.

"After all, airlines are not going to jointly buy aircraft, or take turns developing information technology systems if alliance partnerships may dissolve," according to the report. With major airlines committing to alliances, the focus will shift to second- and third-tier carriers, particularly those hampered by lack of capital or management expertise.

The report also points out that the inclusion of Asia Pacific carriers was the missing link in global alliance-building. While Asia Pacific airlines previously expressed little interest in joining alliances, several have joined since September 1998. This includes Cathay Pacific and Qantas in the Oneworld group, and Thai's membership in the Star Alliance. Several Asia Pacific carriers are also looking for equity investors at the same time that Asia Pacific governments are embarking on efforts to privatise airlines.

"With Star and Oneworld both having footprints in Asia, the race is on for Delta and Wings to complete their global effort by securing an Asia pacific partner," the Merrill Lynch reports maintains. AC