Observations on Airline Alliances and Joint Ventures

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Perry’s Helpful Distinctions

- Unaligned carriers (Virgin Atlantic)
- Branded Alliances
  - Star (Core UA-AC-CO-LH, total 28)
    - Pacific SQ, NH, OZ, CA
    - Latin TAM
  - Skyteam (Core DL-KL-AF, total 13)
    - Pacific KE, China East, China Southern
  - One World (Core AA-BA-IB, total 13)
    - Pacific JL, CX.
Difference Between Branded Alliances and JV’s

- Example: Star. AC-UA-CO-LH are JV on the Atlantic. Just approved UA-CO-NH on the Pacific
  - Many Star carriers are not part of JV’s, including SK, OS, LX, Brussels, Turkish, Egypt
  - On the Pacific, SQ, OZ, and CA are not part of a Star JV
Benefits to Airlines

• Perry’s Presentation Makes the Case
• Alliances Raise Revenues
  – Double hubs create funnel routes (AMS-DTW, FRA-ORD)
  – Passengers attracted from non-aligned carriers (Virgin Atlantic cannot compete on Kansas City to Hannover)
The Issues Raised by Today’s Topic: Benefits of Alliances vs. JV’s

• Benefits to Airlines
  – Collusion on pricing on routes dominated by the JV (JFK-LHR, ATL-CDG, ORD-FRA)
  – Economies of scale in marketing, creating corporate deals (are these paid for by raising the base price to allow these discounts?)
  – Joint sourcing, cost reduction. This is a transfer from suppliers to the airline industry, economists can’t object to this.
Benefits to Consumers?

• Benefits to Consumers of Alliances
  – Clear benefits to elite flyers
  – Unclear benefits to infrequent flyers

• What are Benefits to Frequent Flyers?
  – Elite FF benefits, lounges
  – Key distinction: ANYONE flying business class gets lounge access, doesn’t require alliances.
  – The value of this perk due to Alliances is for FF’s who are flying economy yet gain access to partner lounges if their elite status is high enough
  – RJG story: 100K hurdle to be an elite with Star for 12 straight years (UA)
    • Receive FF and elite-qualifying credit from intra-Europe on LH, LX, SK, TP, OS
    • I’ve never been in a European airport that didn’t offer some kind of lounge

• Attraction to consumers occurs with branded alliances, doesn’t require JV’s
Benefits of Alliances to Non-Frequent Flyers

• Two benefits:
  – Added capacity on funnel routes (DTW-AMS, ORD-FRA)
  – boarding passes issued for connecting flights, not just initial flight
    • Flying DEN-ORD-FRA-BUD just as easy as DEN-ORD-ROC

• Typical non-FF’s are students and casual travelers making that one trip every year or two to Europe

• They care about price, not Alliances

• Have the Alliances helped or hurt them?
The Basic Pricing Model Introduced by Alliances

• Connecting across alliances is more expensive, the so-called “double marginalization” penalty
  – If I fly AA ORD-FRA and then LH FRA-BUD, I pay more than flying UA/LH ORD-FRA-BUD
• Thus studies of airline pricing show that alliances reduce prices
• But compared to what?
  – Did alliances reduce fares or were fares on non-partner connections increased?
The Lost World of Transatlantic “Roaming”

• Pure mileage based fares, valid on any IATA airline. Here’s my itinerary in 1970 on a “M115” fare, that is, any flight keeping within 115% of the allowable mileage was OK

• Contemplate how you could do this kind of trip today? You’d have to buy separate fares – transatlantic, then local within Europe. No wonder Ryanair thrives
Here’s What College Students Would Like to Do Today

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What do JV’s Add to Branded Alliances?

• For consumers, they add nothing
  – Airlines struggle to find consumer benefits
    • AA-BA half-hourly service JFK-LHR
  – Skyteam may have increased schedule coordination, but for Star this was done at least a decade ago
    • LH 430 FRA-ORD has departed at ~10am for decades (same flight number since 1957!)
    • UA 941 FRA-ORD has departed at 12:45pm for two decades

• Is price competition choked off?
The Leading Advocate That Alliances and JV’s are Anti-Competitive: Hubert Horan

• His case refers only to the Atlantic:
  – After 2003 price (i.e. revenue/pax) rose much faster on the Atlantic than U. S. domestic or other regions (Latin/Pacific)
  – The reason prices rose so much was collusion among alliance partners

• The outcome “overturned the laws of supply and demand”
  – Why? Because not just price but capacity increased on the Atlantic compared to other regions
History of Airline Antitrust Immunity

One brief period when ATI created Consumer Benefits

- Thousands of markets got online service, discount fares for the first time

the original collusive alliances KL-NW (92) and SR-DL (95): new double-connect service

Benefits only possible on the North Atlantic

- No similar network opportunities Trans-Pacific or Europe-Asia

Original Alliances thrived in competitive market

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<th>Year</th>
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<td>Top 3 Share</td>
<td>35%</td>
<td>42%</td>
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<td>45%</td>
<td>47%</td>
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<td>Number of US-EU Competitors with minimum departure share of 2%</td>
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Post-2004 Consolidation has created market power

North Atlantic Passenger Fares Have Risen 3X Faster Than US Domestic Fares since Extreme Consolidation began in 2004

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<th>Total North Atlantic</th>
<th>1991</th>
<th>2001</th>
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<td>Concentration-top 3</td>
<td>51%</td>
<td>47%</td>
<td>98%</td>
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<td># Competitors (&gt;2%)</td>
<td>15</td>
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Anti-competitive impacts confirmed by preliminary 2010 pricing data

Artificial Market Power on North Atlantic drove rapid 2010 price recovery not seen in Domestic or Other International markets

DOMESTIC rev/pax
ATLANTIC rev/pax
INTexclATL rev/pax

post 2004 market power defied laws of supply and demand
Domestic fares +15% because seats only +1%
Atlantic fares +46% despite seats +45%
The Big Question: How To Interpret Big Price Increase on the Atlantic

- Horan says this “overturns supply and demand”
- Yet when economists see big increase in output and price together, they automatically (econ 101) conclude that the demand curve has shifted rightwards more than the supply curve
- Thus another interpretation is that rising Atlantic demand outstripped increase in supply (i.e., ASMs)
The Dog That Did Not Bark: Operating Margins

• Collusive pricing should have raised margins on Atlantic compared to other regions

• The period this is supposed to have occurred in 2003-2008 (pre-recession)

• Yet what do we find in the DoT data?
Operating Margins by Division, US Legacy Airlines, 1990-2010

Figure 1. Operating Profit Margins by Division, U.S. Airlines, Four-Quarter Moving Average of Quarterly Data, 1990-2010
Airline Profits, Ratio Atlantic to Other Regions, 1990-2010

Figure 2. Operating Profit Margins, U.S. Airlines, Atlantic Division minus Latin and Pacific Divisions, Four Quarter Moving Average of Quarterly Data, 1990-2010
Brueckner’s Economic Evidence

• Alliances Lower Fares
  – Compared to What?
  – Compared to Connecting Fares of Non-Aligned Carriers

• This Entire Line of Research is Vulnerable to the Accusation that the non-aligned internet passenger is not the right baseline
Brueckner Findings

• The data include only point-to-point fares, e.g., Kansas City to Budapest, where the traveler returns on the same route (BUD-MCI)

• *Hamlet without the Prince*
  – Nonstop point-to-point service on foreign or domestic carriers, e.g., JFK-NYC or FRA-ORD
  – Regional feeder service, e.g., LNK-ORD-FRA

• The results tell us what we already know, that in today’s environment you pay extra to connect across alliances, e.g., AA ORD-FRA and then LH FRA-BUD

• None of this evidence denies that the current pricing structure which forces mark-ups across non-alliance fares is optimal or desirable.
The Bottom Line for the Non-FF Consumer

- Starting in 2003, the low-price leader, the “Southwest of the Atlantic”, the KL-NW joint venture, was stifled by the merger between KL and AF.
- Price competition has gradually been suppressed.
- Here’s an example, my own trip ORD-NUE in June
  - Expedia, round trip, Wed 6/15 to Sun 6/19
  - Only fares available on any airlines range from $1600 to $1750. No competition left.
Conclusion

- **Branded Alliances**
  - They are great for frequent flyers
    - Lounge access even when flying economy
    - Help to accrue elite status
  - Benefits are marginal for non-FF’s
    - Connecting flight seat assignments typically not available in advance
    - Boarding passes are issued

- **Joint ventures**
  - No benefits for consumers
  - Opens the way for price collusion
  - May make airlines more efficient, with possibility of reduced costs being passed on to consumer