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A Conversation with
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Next-generation regional carriers have advanced from once-junior operators to prominent forces within the U.S. air transport industry.

■ By Michael Clarke | *Ascend* Contributor

Once considered secondary players in the U.S. domestic airline system, regional airlines have evolved to become powerhouses that now play a major role in overall network operations. The global airline industry is heavily impacted by external geopolitical and economic forces that drive its very existence and shape the prevailing environment for efficient and profitable operations.

As U.S. network carriers tried in earnest to deal with the aftermath of terrorist attacks, economic downturns and the dramatic rise in fuel prices, regional carriers were given a greater role in shaping airlines' networks. And when major network carriers began focusing on more lucrative international routes, they worked with their regional partners to counter not only the rise in fuel costs but also the advent of low-cost carriers that now have a significant presence. In this ever-changing landscape, the relationship between network carriers and their regional partners have evolved from being one of a dominant master and subservient subject to one of business partners sharing a common goal of maximizing profitability through cost-effective and efficient operations.

The relationship between network and regional carriers is typically governed by a capacity purchase agreement, or CPA, that usually involves a fixed fee for departure or cost-plus contract. Under the bylaws of these agreements, regional carriers were restricted to operate a limited number of aircraft below an agreed seat capacity and on specific routes through specific pilot scope clauses, and they were, in effect, under the strategic control of the network carrier. When the dominant carriers increased the number of outsourced lower-density routes to regional subsidiaries, the regional airlines' profitability increased since they were guaranteed a given profit margin in light of the prevailing market conditions.

Under these capacity purchase agreements, network carriers assume all the market risk and are responsible for commercial planning, revenue management, marketing, sales and distribution of the airline product, and they generally assume high risk items such as aircraft ownership and insurance as well as fuel costs. The regional carrier operates the flight and ensures the availability of capacity for the major airline. In their glory days, regional

carriers were able to command target operation margins ranging from 10 percent to 15 percent under most CPAs, which were usually re-evaluated on an annual basis.

Within the last decade, regional carriers that were once wholly owned and/or managed by an individual network carrier now have the freedom to operate flights for multiple partners. This change in policy and operations was not easily achieved but was an outgrowth of



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Regional carriers have risen above their underdog stereotype to become some of the industry's most prominent players. Mesa Airlines, Continental Airlines, Northwest Airlines and Delta Air Lines all rely on their regional carriers to maintain a successful operation.

Regional Airline Group Flying Assignment

Regional Airline	Network Partner (Percent of Operating Revenue)
ExpressJet	Continental Airlines (70%) Delta Air Lines (20%) ExpressJet Brand (10%)
Mesa Airlines	Delta Air Lines (17%) Mesa/Go! (6%) United Airlines (36%) US Airways (41%)
Pinnacle Airlines	Continental Airlines (12%) Northwest Airlines (70%) United Airlines (8%) US Airways (12%)
Republic Airlines	American Airlines (9%) Continental Airlines (14%) Delta Air Lines (30%) Frontier Airlines (3%) United Airlines (20%) US Airways (24%)
SkyWest Airlines	Delta Air Lines (65%) United Airlines (35%) Midwest Airlines (new)

Source: Company Reports

The percentage of operating revenue the mega-regional carriers receive from each network carrier is based on their current contract agreements.

the challenging negotiations between network carriers facing bankruptcy reorganization and regional carriers eager to preserve their high level of profitability. As a result of these contract negotiations and concessions, regional carriers won the right to seek new flying opportunities, diversify their operations and have much more control over their future fortune.

During the reorganization process, network carriers such as Delta Air Lines, Northwest Airlines, United Airlines and US Airways put out almost all of their existing regional flying for bidding, and other regional airlines were quick to compete for the contracts. Regional carriers were forced to accept lower profit margin targets (less than 10 percent) on new contracts or face the complete loss of flying for a given network carrier. In addition, some regional carriers were required to share in the risk of fuel and insurance costs. As a result, many network carriers now have multiple regional partners serving multiple airports within their system network.

Although most regional aircraft assignment decisions have been driven by economic

needs, network carriers also consider the impact of labor relations at the regional carrier. Since most regional carriers enjoy very flexible and favorable work rules, their cockpit crews are able to fly more time than their network carrier counterparts. Regional carriers that maintain a low cost structure and are not unionized often win more contracts for flying from network carriers.

In light of the labor relationship breakdown and subsequent three-month pilot strike at Comair in Cincinnati, Ohio, in early 2001, network carriers started to re-evaluate the sole regional carrier reliance at major hub airports. As one of the largest regional carriers in Delta Air Lines' network, the shutdown of Comair severely impacted its operations at its secondary hub and resulted in lost market share. In the aftermath of this prolonged strike, Delta Air Lines chose to fully diversify its regional operations at all of its existing hub airports, including Atlanta, Georgia; Cincinnati; Dallas/Forth Worth, Texas; New York, New York; and Salt Lake City, Utah. Other network carriers subsequently followed this strategy to prevent the same dilemma.

During the bankruptcy process, Delta Air Lines used its freedom to reallocate existing air-

craft and new aircraft deliveries among regional partners, driven, in part, by economics as well as labor considerations. As pilot unions at the mainline carrier started allowing more large-sized (less than 76 seats) regional aircraft, Comair was prevented from receiving these aircraft.

As network airlines exerted their pressure on regional carriers, some regional carriers devised creative ways to circumvent the agreed-upon restrictions. Since most capacity purchase agreements were specific to a given carrier and operating certificate, regional carriers such as Mesa Airlines and Republic Airlines simply set up holding companies that either acquired another existing regional carrier and/or started a new subsidiary to fly for another major network carrier. In effect, the cozy relationships between network and regional carriers have given way to very competitive contract negotiations and agreements.

This phenomenon is now common in the marketplace, and there have emerged five major regional carrier powerhouses that dominate the U.S. domestic system — ExpressJet, Mesa Airlines, Republic Airlines, Pinnacle Airlines and SkyWest Airlines. As regional carriers tried to diversify their portfolio of operations, network carriers pursued a similar strategy to the point that some network carriers now coordinate regional flying by seven partners, and some regional carriers fly for six different network carriers.

Regional carriers that once focused their operations on a specific geographical region of the country were now faced with multiple hub operations and often a diverging fleet with multiple equipment types. With this change in operating conditions came increased infrastructure costs as well as greater pilot training needs and associated costs. Nonetheless, many regional carriers have figured out the correct formula to make this new paradigm work for them and maintain profitability at acceptable margins.

Changes in the working relationship between major network carriers and their regional partners were also complemented by changes in the overall ownership structure of the regional carriers. In some cases, such as Continental Airlines with ExpressJet and Delta Air Lines with Atlantic Southeast Airlines, the regional subsidiary was partially or fully divested via an initial public offering or a complete sale to another regional carrier. In other cases, such as Northwest Airlines, the major network carrier decided to secure complete ownership of some of its regional partners (Mesaba Airlines) and at the same time set up an entirely new regional carrier (Compass Airlines) to fly larger regional jets. Each business decision has been driven by the desire to achieve lower operating costs and better terms and conditions under the capacity purchase agreements between major network carriers and their regional partners.

The strength of the new-generation mega-regional carrier was demonstrated during the bankruptcy of US Airways when two regional carriers — Air Wisconsin and Republic Airways — each invested US\$125 million in the major



Regional Partners for Major Network Carriers

Major Network Airline	Regional Partner (Number of assigned aircraft/on order)
American Airlines	American Eagle - 297 Chautauqua (Republic) - 15 Trans States Airlines - 18
Continental Airlines	Cape Air - 3 Chautauqua (Republic) - 44 Colgan Air (Pinnacle) - 11 (4) CommutAir - 16 ExpressJet - 205 Gulfstream International Airlines - 24
Delta Air Lines	Atlantic Southeast Airlines (SkyWest) - 161 Big Sky - 10 Chautauqua (Republic) - 37 Comair - 141 ExpressJet - 18 Freedom Airlines (Mesa) - 42 Pinnacle - 16 Shuttle America (Republic) - 15 SkyWest Airlines - 91
Northwest Airlines	Big Sky - 8 Compass Airlines 1 (36) Mesaba Airlines - 53 Pinnacle Airlines - 133
United Airlines	Air Midwest (Mesa) - 10 Chautauqua (Republic) - 7 Colgan Air (Pinnacle) - 6 GoJet (Trans States Airlines) - 25 Mesa Airlines - 65 Shuttle America (Republic) - 28 SkyWest Airlines - 156
US Airways	Air Midwest (Mesa) - 4 Air Wisconsin - 70 Chautauqua (Republic) - 9 Colgan Air (Pinnacle) - 28 Mesa Airlines - 62 Piedmont Airlines - 55 PSA Airlines - 49 Republic Airlines - 36 (12) Trans States Airlines - 7

U.S. network carriers partner with several regional airlines that serve a variety of routes using anywhere from one to nearly 300 of the regional carriers' aircraft.

network carrier in exchange for guaranteed flying once the network carrier emerged from bankruptcy protection. At the time, Air Wisconsin was on the verge of losing its partnership agreement with United Airlines as they could not agree on favorable terms for the capacity purchase agreements.

A similar fate occurred with Atlantic Coast Airlines, which decided to fly as an independent carrier and later failed and went out of business entirely. As part of its agreement with US Airways, Republic Airways assumed the operations of the recently formed MidAtlantic Airways and took over its entire young fleet of Embraer 170 E-jets.

Today, these airlines play an integral part of US Airways' regional network, whose regional aircraft fleet size almost equals that of the mainline fleet.

Regional carriers that once relied on their network partners to finance new aircraft acquisitions are now in a position to purchase their own aircraft outright and dictate with which network carriers they partner. While they are still restricted by scope clauses, regional airlines have found creative ways to introduce larger jets such as installing multiple service cabins onboard.

The growth of the U.S. regional carrier sector during the last decade has been phenomenal, with six carriers achieving "major" status as defined by the U.S. Department of Transportation. These include American Eagle, Comair, ExpressJet, Mesa Air Group, Republic Airways and SkyWest Airlines. An airline is considered a major carrier if its annual operating revenue exceeds US\$1 billion.

As network carriers continue to offload more domestic flying to their regional partners, this elite group of mega-regional carriers will continue to grow and further play a substantial role in shaping the future of the U.S. domestic airline network. U.S. regional carriers transport in excess of 100 million passengers annually and account for an estimated 12.5 percent of the available seat miles in the domestic network. What is unclear today, however, is which regional carrier will be aligned with which network carrier as each sector continues to pursue the most favorable capacity purchase or pro-rate agreement that meets their operational goals. **F**

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