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AN ALLIED FRONT

A conversation with …

Geoff Dixon, CEO, Qantas Airways

INSIDE

wearelistening@sabre.com

The Evolution of Alliances

From their early beginnings as basic partnerships between airlines, today's global alliances have evolved into a major force that is helping to reshape the aviation industry.

By Shane Batt | *Ascend* Contributor

Global alliances have become worldwide brands. Virtually all frequent international travelers are familiar with **one**world, SkyTeam and Star Alliance. In fact, they account for more than 60 percent of global air capacity. Given how prominent they have become, it is difficult to remember that global alliances are a relatively recent phenomenon in the aviation industry. The main global alliances have been active for less than a decade. Before the alliances formed, of course, airlines cooperated extensively on flights, but even codesharing is a fairly recent innovation that only became prominent within the last two decades.

To paraphrase the English philosopher Thomas Hobbes, prior to global alliances, worldwide travel was "nasty, brutish and long." Individual airlines have lacked true worldwide coverage since the collapse of the first Pan American Airlines more than 20 years ago. Even before the ultimate demise of Pan-Am, the carrier's network shrank rapidly, and many of its more exotic locations were extremely difficult to reach. Airlines did not coordinate schedules; they lacked ticket and baggage transfer agreements, and they did not share airport facilities. Flying from Mexico City, Mexico, to Karachi, Pakistan, 20 years ago, for example, could take days and several intermediate stops to switch airlines. Although the development of global alliances increased the ease of travel for road warriors, this was not the main reason they were formed.

Global alliances developed primarily as a way to improve returns for stakeholders by increasing profitability of member airlines. By obtaining feeds from other members and sharing the revenues of the total ticket prices, members of a global alliance gain access to new revenues without the associated costs of carrying the passengers. Secondly, global alliances enable their members to share resources including airport facilities, sales offices and maintenance facilities, which reduces unit costs. As a byproduct, the formation of global alliances included benefits for customers, such as increased connectivity as well as a worldwide reduction in average fares as the different alliances competed for long-distance travelers.

The evolution of these partnerships, which began with basic bilateral agreements between airlines, has added layers like a Russian nesting doll to become a highly integrated business relationship.

In the Beginning

Today's global alliances are only the outermost layer of the relationships among airlines. At the core of the global alliance relationship is the special prorate agreement, or SPA, which is essentially a ticketing agreement that establishes a set price to be paid by the ticketing airline to the operating airline. The SPA also establishes the fare rules and fare-class alignment that determine how much space a participating carrier can reasonably expect on the other airline. SPAs are vital because in their absence, an airline flying relatively short distances to connect to a long-haul member would have little incentive to feed traffic to its partner. Still, the SPA is generally one of the most difficult negotiation items in an alliance

THE HIGH•LEVEL view

News Briefs from Around the Globe

Who

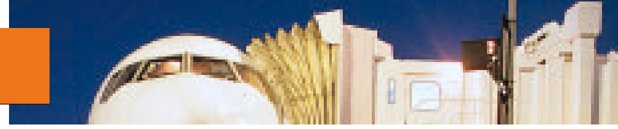
Air Blue

What

Selected the *SabreSonic™ Passenger Solutions* to manage its entire reservations and departure control operations. The airline will also implement the *Sabre® Load Manager* to produce optimal aircraft loading plans.

Why

"As a start-up carrier, Air Blue needed a flexible passenger management solution capable of adapting to the future changes in the marketplace," said Tariq Chaudhary, chief executive officer of Air Blue. "The *SabreSonic* solutions give us the competitive advantage we needed and the functionality to respond to future market changes whilst delivering a solution with bankable results."



because it is highly technical, and proper allocation requires a substantial understanding of market price elasticity, demand forecasts, passenger preferences and several other important factors.

Building on the SPA, the next layer is the codeshare agreement. By codesharing, two carriers that operate between city pairs agree to share space on the aircraft of one or both airlines. By codesharing, airlines increase their network. A connection between two airlines is less desirable than a codeshare between the same two carriers, and even global distribution systems will display on-network connections, including codeshare flights, ahead of off-network connections.

Global alliances typically prefer free-sale codeshare agreements — where each carrier can sell as many seats as are available on the flight without restriction. But all alliances also use block space codeshare agreements, in which the ticketing airline has a pre-determined maximum number of seats that it can sell on a flight that cannot be sold by the operating airline. Building a codeshare agreement is also complex because schedule connectivity must be agreed upon between the two airlines and then maintained through successive schedule, flight time and time zone changes within minimum connection times.

The next layer is the marketing alliance, in which two airlines share marketing and sales resources. Two carriers, for example, will link their frequent flyer programs in an "earn-and-burn" relationship where a traveler can earn points on her host airline while traveling on the partner airline and can also exchange points for flights on the partner airline. In addition to frequent flyer programs, marketing alliances include sharing sales offices, joint advertising, cooperative promotions, joint distribution through various channels and similar marketing cooperation. Marketing alliances are the genesis of the global alliance, and they are a very sophisticated relationship between two airlines.

The outermost layer is the global alliance, which expands the marketing relationship among multiple carriers that offer market coverage over a significant portion of the world. Global alliances share not only commercial resources but also operating resources, such as airport terminal space, departure and premium lounges, ground equipment, and even maintenance facilities. Because global alliances are built on each member generating as much revenue as possible at the lowest possible unit costs,

Joining An Alliance

By Robert Westgate | *Ascend* Contributor

During the next few years, carriers will not decide whether they should join an alliance but rather when and how integrated they want to become in this type of network relationship.

Joining an alliance or developing a codeshare agreement provides several benefits:

- Access to more extensive distribution channels,
- Access to frequent flyer programs,
- Increased pricing power,
- Possibility of increased feed traffic,
- Decreased risk for entering new markets.

Therefore, most carriers will develop some form of network partnership; it is just a matter of choosing the right partners and type of agreement.

Sabre Airline Solutions Consulting has developed an alliance checklist from its varied alliance development engagements that can assist carriers in developing a successful network partnership and make them aware of issues that can arise when evaluating and joining an alliance.

As airlines look to join with new partners, they should:

1. Evaluate the carriers under consideration according to:
   - A. Quantitative factors:
     - i. Type of codeshare (hard or soft block of seats),
     - ii. Value to partner seats,
     - iii. Cost of selling seats,
     - iv. Revenue sharing,
     - v. Inventory coordination/management,
     - vi. Frequent flyer program liability.
   - B. Qualitative factors:
     - i. Strength of the carrier (name recognition in the market place),
     - ii. Network value (market access and value of those markets),
     - iii. Other carriers' interest (additional traffic opportunities),
     - iv. Implementation duration (system requirements),
     - v. Regulatory issues (open skies availability),
     - vi. Customer expectations (identifying and managing expectations):
       - a. Opportunities for frequent flyer members (increased mileage),
       - b. More flights,
       - c. Synchronized schedules,
       - d. Pricing coordination,
       - e. Smooth reservations and ticketing,
       - f. Single check in,
       - g. Streamlined airport procedures,
       - h. Easy connections,
       - i. Product consistency,
       - j. Expanded reservations network,
       - k. Knowledgeable employees.

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member airlines share resources wherever possible. Global alliances are increasingly negotiating common agreements with manufacturers, maintenance providers and similar vendors.

Emergence of Global Alliances

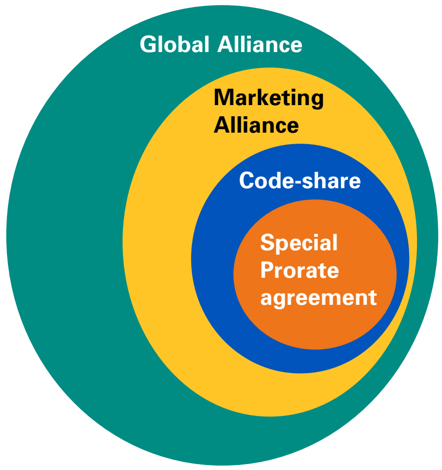
Because of their complexity, it is little wonder that global alliances are a fairly recent development. In fact, they probably would not have evolved at all if not for the deregulation of the industry that is, even now, a process that is not complete globally. Prior to deregulation, airlines had a built-in profit margin that meant they could survive without much difficulty. Prior to deregulation, most airlines were government owned (or at least partially government owned) and were operated as public utilities.

Deregulation, however, changed the industry dramatically.

Deregulation caused airlines to compete in ways that had never previously been required. To continue to operate, airlines needed to find new ways of operating that would give them more access to revenues at lower unit costs. The volatile business environment that resulted from deregulation led to the development of global alliances.

Although global alliances generally benefit their members, there are advantages and disadvantages to participation. For some airlines, membership in a global alliance has meant the difference between solvency and insolvency. Both Iberia and Aer Lingus benefited from **one**world membership during their successful restructurings. And United Airlines and American Airlines also benefited from the protection they received from their participation in global alliances during their financial difficulties. Global alliances, however, also have disadvantages:

Alliance Structure



Today's global alliances are, like an onion, several layers thick. To function properly, alliances depend on series of agreements between airlines to establish the relationships that make the whole a functioning entity

- Their competition has generally accelerated the reduction in global yields as they compete for long-haul passengers,
- They can restrict the rapid growth of members that must cooperate with partners before expanding capacity in markets,
- Their increased requirements for common technologies and common planning and operating practices can restrict fast-moving partners, which are slowed by their less-sophisticated partners.

Despite the disadvantages, most airlines would credit their alliance membership with substantial financial benefits. And, more importantly, global alliances make individual airlines more competitive.

Alliances have a significant impact on competition because they often have exemptions from anti-trust regulations that allow members to dominate certain markets. Alliance members can also share market information, discuss common pricing, coordinate capacity and schedules, and even discuss competitive actions taken in markets. Increasingly, airlines that are members of global alliances have significant advantages over their competitors that are not.

The impact of alliances on passengers has also been significant. Long-haul passengers favor global alliances because of the advantages they offer, including:

- Electronic ticketing that is easy to change from any participating carrier,
- Through-baggage checking and boarding pass generation across alliance members and the use of common facilities at airports,
- Participation in frequent flyer programs with truly global reach,
- Lower prices for long-haul travel,
- Common quality standards among members.

These significant benefits have little, if any, downside to customers other than the possible increase in fares that results from a reduction in competition.

Global alliances are in their adolescence and, like teenagers, they are "subject to change without notice." While there is no crystal ball to determine the future of global

THE HIGH • LEVEL view

News Briefs from Around the Globe

Who

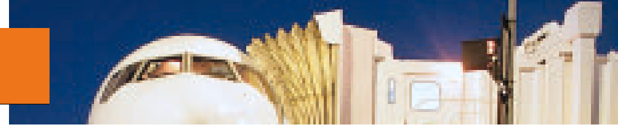
Air China

What

Selected Sabre Airline Solutions Consulting to conduct an extensive gap analysis of its airline planning and scheduling, pricing, and data warehousing operations to help identify inefficiencies and implement industry best practices in those key areas.

Why

"We are very confident that such a thorough examination of our business by the consulting team at Sabre Airline Solutions will prove invaluable in addressing where we are in our business and where we want to be," said Jian Xiong Huang, deputy general manager of information technology for Air China. "Once we have the report, we can allocate IT funds accordingly and target specific business issues with expertly recommended solutions."



alliances, several trends point to an evolution that will change the impact these business relationships have on the aviation industry. While global alliances have already had a significant impact on the airline industry, they continue to evolve along with the changing business environment.

Future Alliance Trends

As global alliances mature, certain trends are appearing that will affect their viability as well as their members, competition and passengers. These trends can be split into four categories:

- Equity participation — Global alliances are increasingly expanding the financial relationships between their members.
- Regulatory framework — Government regulations are changing the landscape of global alliances.
- "Lite" partnerships — Global alliances are becoming more selective about how and when they allow new members to join.
- Procurement partnering — Global alliances are only now beginning to understand the potential they possess to reduce unit costs through common procurement practices. Alliance members will increasingly use this potential to drive favorable supplier rates.

Each of these trends is impacting global alliances but will have greater affects in the future.

Equity participation is evolving along with global alliances. The merger of Air France and KLM Royal Dutch Airlines (see related article on page 4) is the most prominent example of evolving equity participation. Air France was able to use European Union free-trade regulations to purchase a majority stake in KLM, which will now participate in SkyTeam as a full member in cooperation with Air France. Both **one**world members American Airlines and British Airways owned minority stakes in Iberia at one time, and other global alliance members share equity.

In addition, Star Alliance members were asked to provide loans to United Airlines to sustain its capital requirements during its bankruptcy reorganization. The U.S. government is currently considering a bill to loosen foreign ownership regulations on airlines in line with the ownership regulations of the European Union. Easing foreign ownership regulations in other industries (notably, automobile manufacturing) has led directly to consolidation within the sector, and this is a trend that appears set to continue within the aviation sector.

It is doubtful that global alliances will evolve into single mega-carriers due to the high cost of capital and the enormous capital requirements that such ventures would require. Still, it is possible that alliance partners will increasingly tie each other together with equity participation to strengthen their relationships and provide better alignment. Ultimately, however, the level of equity participation among global alliance members will be restricted by the existing regulatory framework.

The regulatory framework is changing rapidly — anti-trust legislation is increasingly being used on the global stage in order to further political agendas. As trade disputes erupt between the North America Free Trade Association and the European Union countries, for example, regulatory agencies are increasingly using global aviation as the testing bed for new regulation.

Despite the desire among passengers for greater flexibility and more services from

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2. Prepare for issues that could have a significant impact:
   A. Business issues:
      i. Governance (establish bilateral agreements in key areas),
      ii. Organization (appoint key officials to manage agreement),
      iii. Safety, quality and security (develop and sign safety, quality and security commitments),
      iv. Brand and advertising (set and adhere to guidelines),
      v. Communication (coordinate product offering and announcements),
      vi. Signage (install co-branded signage for product identification),
      vii. Training (perform training for front-line staff to ensure consistent customer service).
   B. Operational issues:
      i. Revenue management (implement unified practices),
      ii. Sales (provide training for promotion and sales changes),
      iii. Reservations (ensure systems have functionality to interface with codeshare partners),
      iv. Web site (update to include codeshare partner(s), including FAQs),
      v. Airports (identify and address key issues at terminal and airport facilities),
      vi. Customer care (manage passenger correspondence and address codeshare customer issues at the same level of service as partner carriers),
      vii. Frequent flyer program (estimate and manage program growth),
      viii. In-flight products (perform product audit across alliance and negotiate with suppliers for discounts based on codeshare/alliance relationship),
      ix. IT and financial systems (audit and adjust system to address new relationship and communications needs).

3. Ensure that a partnership plan is implemented successfully by evaluating:
   A. Network plan (develop a long-term, detailed passenger estimate for each carrier and identify route and market phasing plan),
   B. Transition plan (establish internal resource estimates and communication plan that supports implementation and codeshare benefits),
   C. Implementation plan (develop external plan that supports the joint codeshare implementation),
   D. Post-implementation tune-up.

Robert Westgate directs the planning and operations line of business for Sabre Airline Solutions Consulting. He can be contacted at robert.westgate@sabre.com.

global alliances, elected officials are often increasing anti-trust scrutiny. While the European Union and NAFTA are on opposite sides of the debate, they are not the only regulatory bodies impacting global alliances today. Many countries are signing open skies agreements, which foster global alliance relationships because they remove bilateral restrictions to capacity and frequency of air service.

Meanwhile, the E.U. requirement to remove country designators from third-country bilaterals is meeting resistance from non-E.U. countries as well as countries that do not belong to a large trade pact such as NAFTA. In recent discussions between a Japanese and a European airline, the issue of bilateral restrictions was broached with the Japanese government, which said that it would not allow the European carrier to operate to Japan because its ownership was not majority held in the European country in which it was based.

Such issues could, for example, cause problems for airlines such as KLM, a Dutch company whose majority ownership will be in France. Certainly, as global alliances become more pervasive and complicated, the regulatory environment will also become more thorny. This added complexity might make more limited participation in a global alliance attractive.

As global alliances become more complex, a trend toward "lite" membership could accelerate. Under lite agreements, an airline becomes an associate member of a global alliance to obtain most of the benefits of participation without the requirements of full membership.

In the SkyTeam's associates program, for example, a full member may sponsor an airline for the associates program through which it only participates on certain routes and with certain restrictions while receiving access to common resources such as frequent flyer links, branding and promotion. This form of lite membership is desirable for both the current alliance members as well as new associates. Existing members can observe the business practices of associate members without fully committing to partnership. The associate members can ease their way into the alliance without having to make all of the necessary business and technical changes at once.

Lite participation will also certainly entail fewer regulatory issues than full membership. The risk, however, is that lite membership may lead to a two-tier structure where the more junior members of the alliance have fewer benefits and more burdens than the full members. For example, CSA Czech Airlines, a smaller carrier, is a full member of SkyTeam while Malev, a partner of CSA that is actually slightly larger than the Czech airline, may only be allowed to enter SkyTeam as an associate member. Such lite memberships should be watched carefully to see if they evolve successfully for all participants.

The final alliance trend is toward procurement partnering. When global alliances were first formed, one of the envisioned benefits was the purchasing power members would enjoy. For the most part, however, these advantages have not been a significant contributor to profitability of individual airlines. This lack of impact may soon change. When oil was around US$20 a barrel, airlines had little incentive to enter large procurement partnerships for fuel.

Purchasing economies that could be realized through procurement partnering are small at US$20 per barrel. Today, oil, at more than US$40 per barrel, is considerably higher, and procurement partnering among alliance members becomes much more attractive. Other procurement partnering is already taking place with manufacturers, maintenance providers, ground handlers, catering companies and similar suppliers, and it is a trend that is sure to grow.

Global alliances will continue to evolve as business conditions change. Some of the evolution will benefit members and some will not. One rule of evolution, of course, is "survival of the fittest."

Unraveling Global Alliances

Perhaps the most worrying characteristic of global alliances is that they are not easy to unravel. Alliance members share many resources: commercial, financial, operational and technical. While sharing resources is one of the primary benefits, it also exposes a weakness. What happens when a primary member of an alliance dissolves? Several large members of global alliances are struggling for financial stability. The failure of any of these carriers would have a profound impact on the health of its alliance partners.

When the Wings alliance led by Swissair unraveled, the ripple effects impacted all members. Although more of a regional than a global alliance, the fate of Wings illustrates the effect of the collapse of a key alliance member. Wings was devastated by the failure of its anchor carrier. Almost all of the former members of the Wings alliance have gone out of business or suffered financial hardship following the collapse of Swissair. With rising fuel prices, dropping yields and increasing competition, it is difficult to imagine that all of the troubled carriers will survive, threatening the health of the current alliances.

Global alliances improve the passenger experience and benefit member airlines. Even with the challenges they face, global alliances can look forward to a healthy future — even if individual members continue to struggle.

Shane Batt is a partner with Sabre Airline Solutions Consulting. He can be contacted at shane.batt@sabre.com.

+count it up

700 million — Euros per day, according to the International Air Transport Association, that aviation contributes to the tourism industry in Europe, creating considerable employment in the aircraft and engine manufacturing industries.

12 — Percent of possible fuel savings the European Organisation for the Safety of Air Navigation, or EUROCONTROL, estimates could be generated by minimizing the inefficiencies in air traffic management systems, according to the International Air Transport Association.

3 — Number of doctors who delivered a baby aboard a KLM flight from Amsterdam to Chicago Aug. 18. The Jordanian woman and her healthy baby daughter were taken to a local hospital in Newfoundland, Canada, where the aircraft made an emergency landing.