Airline Alliances and Systems Competition

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Overview

- Current state of alliance markets
- Possible competitive paradigm
- Competition and antitrust immunity
- Alliances as systems
- Policy considerations

Observations

- Open Skies, codesharing, and antitrust immunity are three mechanisms for promoting liberalization
- Alliances extend cooperation to levels of integration that sometimes mimic mergers or joint ventures
- Alliances are becoming larger and fewer
- Empirical evidence is no longer unequivocal in favor of the benefits of antitrust immunity
- DOT's policy goal of promoting end-to-end (i.e., systems) competition in alliances hinges on antitrust immunity

International Airline Alliances

- Star
  - United/Lufthansa
  - Immunized
- SkyTeam (Wings + SkyTeam)
  - Delta/Air France/Northwest/KLM
  - Partly immunized, request for full immunity pending
- oneworld
  - American/British Airways
  - Un-immunized

The "Double-Edged Sword" of Antirust Immunity

- Antitrust immunity covers coordination involving
  - Revenue sharing and pricing
  - Distribution systems
  - Route planning
- Benefits of coordination (efficiencies)
  - Eliminates double margins, reduction in transactions costs
  - Enhances network effects through scheduling of connecting flights and coordination of gate location and baggage handling
- Costs of coordination (higher fares and reduced choice)
  - Eliminates horizontal competition
  - Provides incentives to foreclose non-alliance rivals from providing interlining services at alliance hubs or to otherwise raise their costs

Policy Questions

- Do pro-consumer benefits from coordination among alliance members allowed by antitrust immunity outweigh potential harm from diminished competition?
- Is immunization required to achieve policy objectives such as liberalization that might take precedence over consumer welfare?
- Is there enough "systems" competition to support continued grants of immunity?
  - Less competition – more concern about intra-system issues and elimination of horizontal competition
  - More competition - less concern about grants of immunity

Systems and Airline Alliances

- Linked hub-and-spoke airline networks form integrated system of complementary markets
- Hubs and access to gates, slots, and other infrastructure are interfaces that link markets
- Other examples of systems
  - Original equipment/parts and service
  - Agricultural biotech/genetically modified seeds
  - Electric generation/transmission

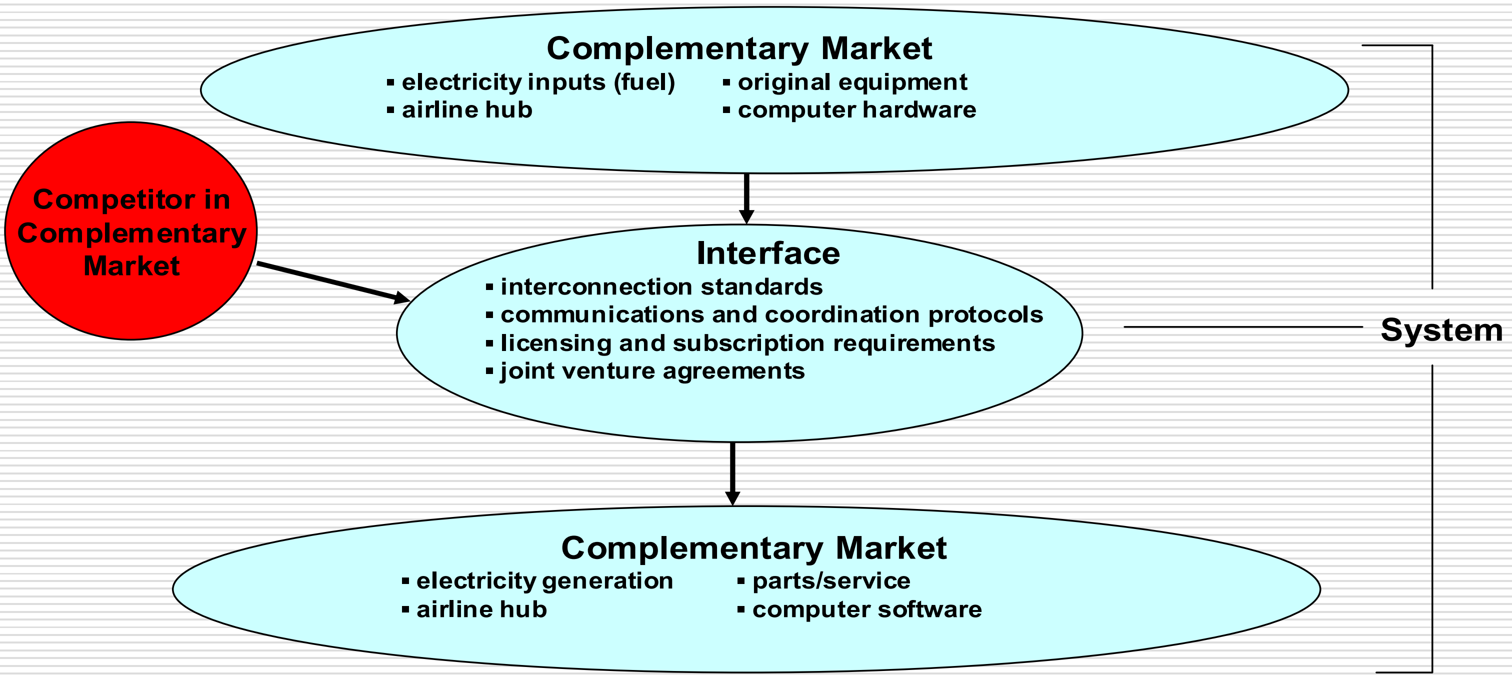
Economics of Systems

- Economies of scale (supply side)
  - Incremental utilization of system components lowers average costs
  - Increased traffic density on hub-to-hub flight segments
  - Capacity constraints at hubs (slots, gates, etc.) can create dominance
- Network effects (demand side)
  - Value of product or service increases as additional users join the system
  - Additional service at hub expands routes and increases flight frequency
  - Switching costs, lock-in effects, and tipping to a single system can create dominance

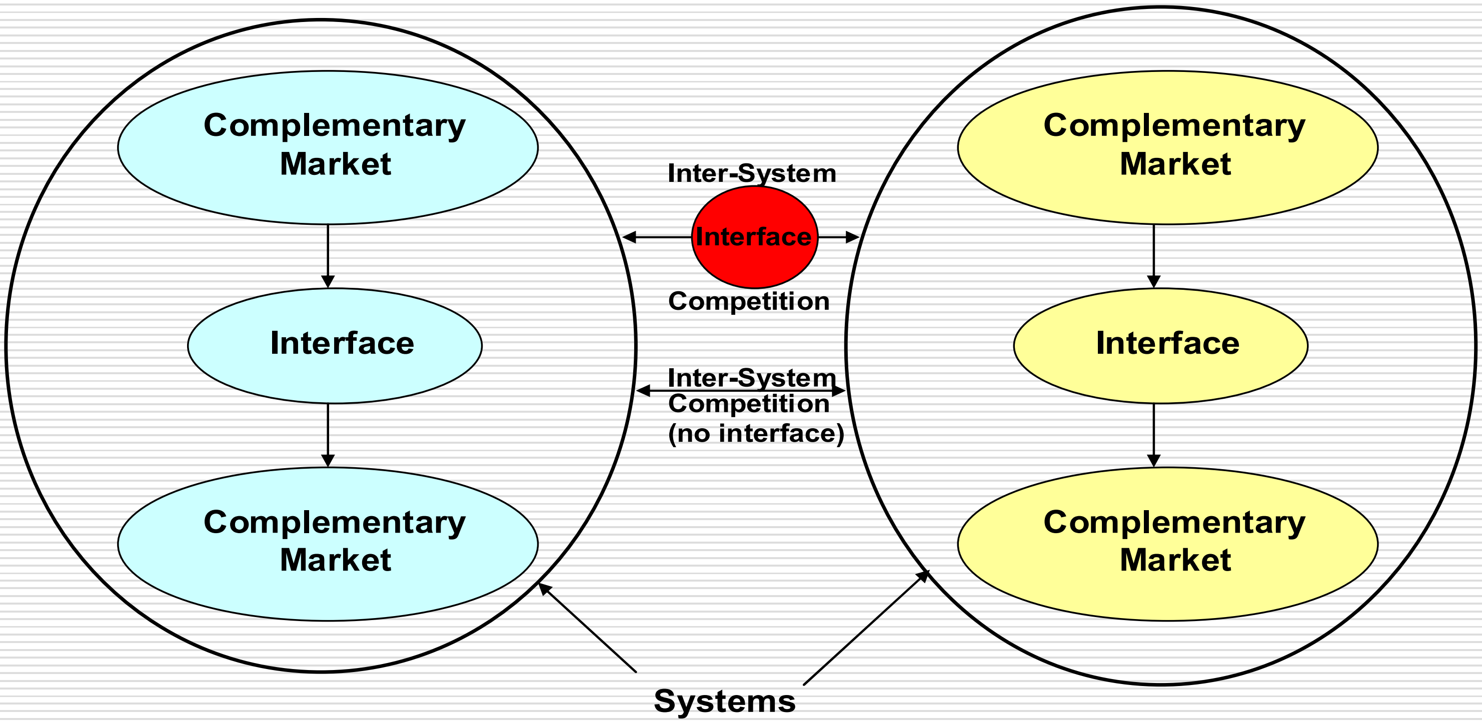
Competitive Issues and Systems

- Consolidation to form systems
  - Removal of rivals that eliminates horizontal overlaps
  - Mergers or joint venture arrangements
- Intra-system competition
  - Ability of a rival to access interfaces and a complementary market in a system
  - Regulatory discrimination and access problem (*Otter Tail), a*ntitrust exclusionary conduct problem (*Kodak)*
- Inter-system competition
  - Head-to-head competition between two rival systems
  - Number of systems necessary to provide competition?

Intra-System Competition



Inter-System Competition



Horizontal Effects of Immunized Alliances

- Diminution of competition in overlapping gateway-to-gateway markets and on connecting routes using hubs of alliance members
- Department of Justice and Transportation Research Board recognized potential problems in late 1990s
- Alliances in close proximity impose the most competitive discipline, so expansion of alliance membership to include proximate rivals is potentially problematic

Vertical Effects of Immunized Alliances

- Non-alliance members may be foreclosed from interlining with alliance member at alliance hub, "diverting their feed traffic and weakening route structures" (TRB at 5)
- Department of Justice and Transportation Research Board recognized potential problems in late 1990s
- Higher prorate charges and reduced seat capacity can affect costs and expansion plans of non-alliance members, particularly if the hub is an essential component of serving an origin-destination pair
- Number of conditions necessary to raise rivals costs (e.g., few alternatives to interlining for non-member carriers, inability to divert passengers)

Empirical Evidence on Immunization: Pre-2000 Studies

- Immunized alliance carrier fares were 18-28% lower than non-alliance carriers (Brueckner and Whalen, 2000).
- Fares fell by 20-25 percent in Open Skies markets (DOT, 2000)
- Output expansion (especially with respect to connecting traffic) and faster growth in passenger traffic (DOT, 1999 and 2000)

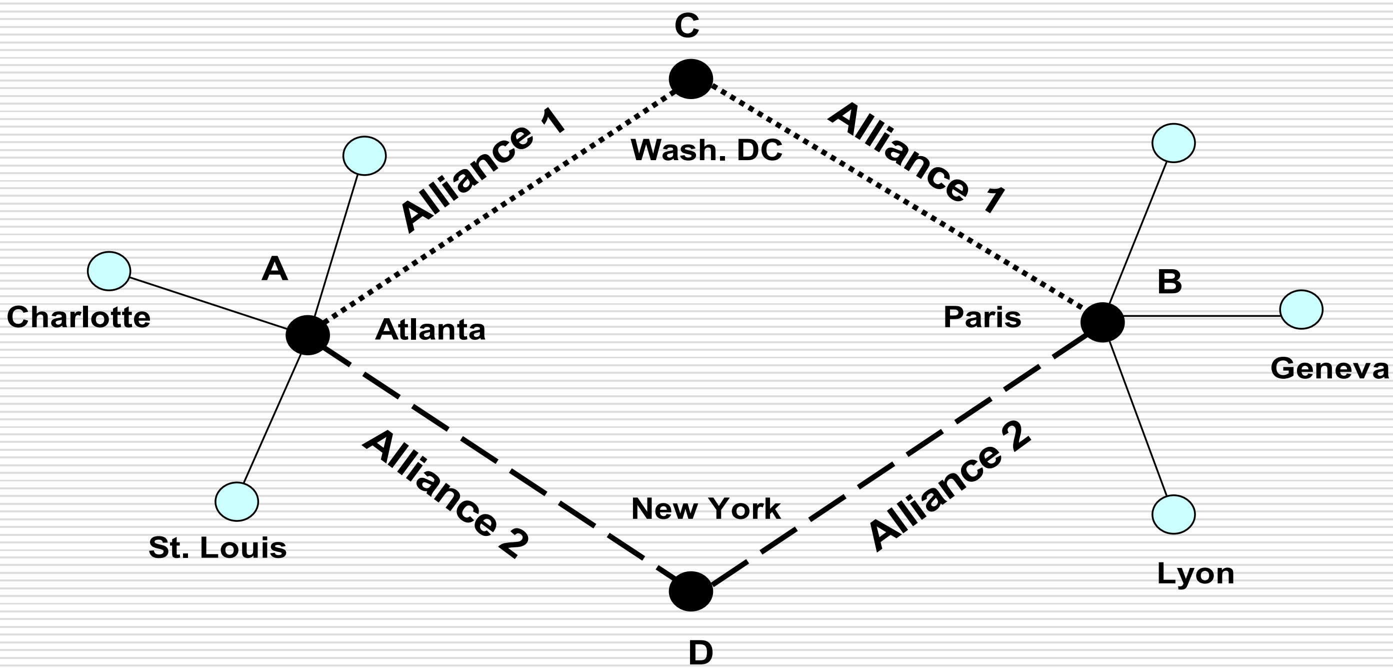
Empirical Evidence on Immunization: Post-2000 Studies

- SkyTeam fare increases of 4-5% on certain gateway-to-gateway routes involving U.S and France (Reitzes, Robyn, Neels, 2005)
- Update of DOT data show 12-15% increases in fares in Open Skies markets
- Air France restricted inventory available to non-SkyTeam interline carriers in 2004, reducing number of non-alliance passengers connecting in Paris and Frankfurt

Is There Enough Systems Competition?

- Systems competition requires that alternative connections at gateways be viewed by travelers as good substitutes
- Network structure means that one alliance may have a natural competitive advantage in serving certain markets
- Poor financial performance does not necessarily indicate aggressive price competition (could be high-cost operation due to fragmented markets)
- Benefits of alliances may have reversed due to consolidation of market positions
- Are efficiencies related to Open Skies or immunity?

Competing Airline Alliances



Policy Considerations

- Empirical evidence suggests a reversal of early benefits findings
- Policymakers must wrestle with a number of complex costs and benefits
  - Efficiencies and improved service quality versus
  - Diminished competition, potential incentives to retard growth of competing alliances, and costs of mutual forbearance
- How to deal with problematic requests for immunity
  - mega SkyTeam pending in U.S., of concern in EU
  - Do carve-outs introduction distortions in network competition?