International Airline Alliances

by

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1. Introduction

Today’s extremely competitive market environment makes it almost impossible for any company to survive without partners. As a result of globalization and increased competition the world’s airlines are forced to unite their strength and resources by way of entering into strategic airline alliances. Alliances promote co-operation in a broad scale of commercial and operational areas, thereby enabling competitors to become each other’s strategic business partners. Such co-operations include schedules, marketing, frequent flyer programs and code-sharing.

Airlines have always been viewed as national treasures, thus they have enjoyed very high levels of protection. Consequently, the airline industry has been characterized by a multitude of both technical and economic regulations. The main focus of the national authorities was to protect the interests of sovereign states. This protection was achieved by requiring states to operate air services between each other under bilateral air services agreements. The foundations of the bilateral regime were laid down in the Convention of International Civil Aviation1 (Chicago Convention) which has essentially put governments into the forefront of airline corporate planning.

As a consequence of the liberalization of air transport, airlines, by aligning with each other, attempted to reduce the involvement of governments in aviation. By entering into alliances and sharing each other’s resources, including air traffic rights, carriers managed to gain access to new routes and networks which they previously could not reach due to the strict requirements of bilateral air transport agreements2. The introduction of global airline alliances has brought about a number of significant changes which have resulted in a dramatic metamorphosis of the landscape of the aviation industry. Global alliances have been fairly successful in their attempt to create a more liberalized air transport environment by trying to alleviate the regulatory burden created by the Chicago Convention.

This article focuses on the legal framework of strategic airline alliances, the features and benefits/disadvantages of alliances as well as the future of airline alliances. The paper does not intend to deal with the competition law aspects of airline alliances.

1 Convention on International Civil Aviation signed at Chicago on 7 December 1944, (hereinafter referred to as the Chicago Convention)
2. The regulatory background of strategic airline alliances

Prior to the detailed discussion of global branded airline alliances and their effects on the aviation community it is important to briefly analyze the rigid regulatory framework which gave rise to the evolution of airline alliances.

2.1. The framework of bilateral air services agreements

The regulation of air traffic originates from the Paris Convention of 1919. Article 1 of the Convention states that "every Power has complete and exclusive sovereignty over the airspace of its territory". This means that every state has exclusive sovereignty over its airspace and has the right to refuse the entry of foreign aircrafts into its airspace. Article 1 of the Chicago Convention restates the same principle. The authors of the convention added Art. 6 according to which “no scheduled international air service may be operated over or into the territory of a contracting state except with the special permission or authorization of that state”. The philosophy of sovereignty over airspace, codified by the Paris and later reaffirmed by the Chicago Convention, has become the foundation for bilateral air services agreements between states for the exchange of traffic rights.

According to this principle, two countries that wanted to operate air services between each other were to designate a 'flag carrier' each to serve that specific market from the respective side. The 'flag carrier' was guaranteed traffic rights by its government and was not presented with any kind of competition apart from the other state’s designated flag carrier at the other end. The concept established in the Paris and Chicago Conventions means that the right of access to a state's market is solely based on the contracting state's complete and exclusive sovereignty over its airspace and the equal right of all signatories to participate in international air transport regardless of market competitiveness or the economic strength of the airline.

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5 Birgit Kleymann, Hannu Seristo: Managing Strategic Airline Alliances, Aldershot, Ashgate, 2004, p.1
2.2. Bilateralism/Regionalism

Due to the doctrine of sovereignty over the airspace, the world’s airlines were forced to develop a system of bilateral agreements in order to determine traffic rights, frequencies and capacity of air services. The very first bilateral agreement (Bermuda I) was concluded between the UK and the US. It has set limitations regarding capacity, designation of air carriers, traffic rights and tariffs. This bilateral agreement was used as an example by many other nations who have concluded bilateral air transport agreements between each other. However, many years after the conclusion of Bermuda I, the British have expressed their dissatisfaction with the agreement and decided to draft up a more 'liberal' agreement, called Bermuda II. Unfortunately, Bermuda II turned out to be even more restrictive than its predecessor, thus it has not been widely followed as an example by other countries.

It is important to mention here that certain countries sharing common aviation policies often create an aviation area in which traffic rights are granted on a reciprocal basis to the member states. The best examples for regional arrangements are the co-operation between EC member states and the Andean Pact in South America.

As a consequence of the bilateral regime all major air carriers of the world are either state owned or majority owned by its home country’s nationals. The problem is that under the current regime it is not possible for an airline to sell a majority of its shares to a foreign carrier and still qualify as a designated airline of its state. Investing in majority shares in a foreign air carrier with the aim of exploiting the traffic rights of the acquired carrier is also not allowed.

The strict requirements of the bilateral regime, established by the Chicago Convention, is one of the main reasons why the most 'global' industry in the world is still very much local. By forming international alliances and setting up global networks, the airlines attempt to overcome the rigid restriction set by the current regime.

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11 Ibid. p. 694
2.3. **Substantial ownership and effective control**

The single most important obstacle to mergers between airlines is the requirement of substantial ownership and effective control. Substantial ownership equates to owning more than 50 per cent of the voting shares in an airline and effective control means the power to control a corporation’s internal and external policy\(^\text{12}\). The aim of the requirement is to prevent air carriers from third countries to profit from the bilateral exchange of traffic rights between two contracting states.

2.3.1. **The United States perspective**

Despite its liberalizing efforts, the U.S. continues to both protect its airlines against foreign control and to prevent foreign carriers from obtaining cabotage rights. Currently, U.S. nationals must control 75% of the voting interests and the president and majority of the board members must be U.S. citizens. The 75% requirement was laid down in the Civil Aeronautics Act 1938. The main purpose of the limitation of foreign investment in US airlines is national defense; however, there are also a number of economic reasons for the restrictions. The US practice shows that foreign ownership and control requirements tend to be suspended through bilateral air services agreements if the other party to the agreement is also willing to give up these restricting clauses (reciprocity).

2.3.2. **The European perspective**

The conditions for granting an operating licence are set out under Article 4 of Regulation (EC) No. 1008/2008\(^\text{13}\) on common rules for the operation of air services in the Community (the “Regulation”). The ownership and control requirements of Article 4 (f) require that an undertaking shall be granted an operating licence by the competent licensing authority provided that 50% of the carrier’s capital is held by one or two Member States or citizens thereof. In addition, the airline must be effectively controlled by Member States or their nationals.

The substantial ownership and effective control requirements have prevented airlines to form multinational corporations thus playing a crucial role in forcing them to create alliances.


\(^{13}\) Regulation (EC) No. 1008/2008 on common rules for the operation of air services in the European Community
3. Global airline alliances

The bilateral regime created a very restricted competition environment in the areas of market access, capacity, tariffs and designation of air carriers. The above outlined international regulatory framework of air transport is the main reason for the materialization of alliances. Until recently, the international air transport community had few problems living with the ownership and control restrictions. However, during the past decade these requirements have become straightjacket for many airlines, and a fortiori for international airline alliances, preventing the airlines to form one multinational airline company.  

The major factors that can be considered as regulation-related drivers of airline alliances are tight control over airline mergers and acquisitions, foreign ownership restrictions in airlines by governments and the bilateral regime. With the aim of overcoming these obstacles some of the most 'influential' carriers of the world have joined together to co-ordinate their efforts in establishing global airline alliances. The major airline alliances are described below.

3.1. Current airline alliance groups

3.1.1. Star Alliance

Star Alliance was founded in 1997 and is currently the largest airline alliance in the world consisting of 28 full members. Star is mainly focused on marketing and cost cutting for its member airlines. Members include: Lufthansa, SAS, Thai International and United Airlines. The main goal of the alliance is to create a 'smooth travel experience’. This aim is achieved by locating member airlines closer together at airports, building of common airport facilities (i.e. check-in kiosks) as well as schedule coordination. It is noteworthy that the formal governance of the alliance group is based on bilateral agreements between individual airlines. In order to achieve multilateral governance, a Star management board, called Alliance Management Team was formed with approx. 80 full-time employees, staffed by member airline’s mangers and has its headquarter at Frankfurt Airport.
3.1.2. **Oneworld**

The Oneworld alliance brings together some of the world’s biggest and best airlines including British Airways, American Airlines and Cathay Pacific\(^\text{19}\). Oneworld was the first global alliance to introduce inter-line ticketing between member airlines, which means travellers enjoy smooth transfers and greater flexibility across the entire network. Oneworld is managed centrally from New York City.

3.1.2. **SkyTeam**

SkyTeam was formed between Air France and Delta Airlines in 1999. Other prominent members of the alliance are KLM, Aeromexico, Aeroflot and Korean Air\(^\text{20}\). The US Department of Transportation granted antitrust immunity to SkyTeam which gives access to passengers to all destinations beyond the member carrier’s hub airports. In June 2009 SkyTeam has announced the creation of a new centralized organization for the alliance with its headquarter in Amsterdam\(^\text{21}\). With this move, the governance structure of SkyTeam became similar to Star’s and Oneworld’s which both have management companies.

3.2. **The Main features of airline alliances**

Global airline alliances, regardless of their size and nature, tend to have the following common features. Airlines entering into alliances aim to code share, conclude blocked space agreements, franchise, coordinate/synchronize flight schedules and recognize each of their alliance partners Frequent Flyer Programs (FFP).

Code-sharing is a favoured by airlines as an effective marketing tool. Under a code share agreement there is one airline that operates the flight (operating carrier) but both its and another carrier’s (marketing carrier) codes are being displayed on the board. Code sharing enables airlines to coordinate schedules, transfer baggage, use single check-ins, share airport lounges, share FFP Programs and agree upon which airline is responsible for the passenger’s whole journey by air.

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\(^{19}\) [http://www.oneworld.com/?changeCountry=1](http://www.oneworld.com/?changeCountry=1)

\(^{20}\) [http://www.skyteam.com/about/carriers/index.html](http://www.skyteam.com/about/carriers/index.html)

Block space agreements are closely linked to code share agreements. A block space agreement involves the leasing or the reservation of a specific number of seats by one airline for its passengers to be flown in aircraft operated by another airline. The non-operating carrier buys a block of seats from the operating carrier at wholesale and then it tries to sell them at retail, but it bears the risk if they are not sold. Franchising is also very common in the airline industry. Under a franchise agreement an airline gives permission to another to use its name, livery and even aircraft. Another important feature is the recognition of FFP Programs of partner airlines. This practice enables passengers to receive more mileage points because of the transfer of bonus points between alliance members.

4. Major advantages/disadvantages of airline alliances

4.1. Advantages for the airline

The biggest advantage of alliances from an airline’s perspective is the increase of market presence and the opportunity to benefit from the partner airlines expertise in their respective home markets. So from an airline's point of view the main objective of entering into an alliance is to benefit from the network it provides. Entering an alliance can also mean the airline an increase in revenue as well as cost reduction through the various joint purchasing initiatives and standardisation of products. Price fixing, demand stimulation and traffic growth are also one of the key decision factors when it comes to considering alliance membership. Co-operation with other airlines through franchises, code shares, block space agreements and FFP programs is an effective way of extending the airline’s global reach.

4.2. Advantages for the customer

Alliances provide customers with a seamless travel experience with very low risks of missing connecting flights and losing baggage. Code-sharing arrangements between airlines offer passenger much better connections than traditional interlining. In addition to that, flexible FFP programmes make it possible to passengers to earn miles on one airline and use it on another. But the most important benefit from the customer’s point of view is the fact that due to the alliances broad network, passengers have a very good choice of service to almost any destination on the planet.
4.3. The disadvantages of alliances

Above we have seen the potential beneficial effects of alliances on both the airline and the customer. Alliances, however, can also be disadvantageous. The main disadvantage is that alliances can easily result in limitation of competition, or in other words, anti-competitive practices. The major problem lies behind the fact that alliances that are very strong at certain hubs (i.e.: Heathrow, Frankfurt) have the potential of becoming superpowers at those hub airports, thus creating anti-competitive practices. If such a scenario arises it becomes almost impossible for other airlines to access that market and compete between important city pairs.

To conclude, while such alliances are certainly beneficial for both the customer and the airline, alliances will always prove to be disadvantageous when it comes to competitiveness. Thus, it is crucial for alliances to acquire antitrust immunity from competition authorities. The absence of such authority would force alliance partners to reduce the degree of competition between each other, which would almost immediately result in lost revenue and decreased efficiency.

5. A future outlook on global airline alliances

Airline alliances are truly global, however, they are obliged to operate within the boundaries of the bilateral regime. There are three extreme scenarios drawn up by Kleymann and Seristo, as to the future of alliances. These will be described below.

The first scenario assumes worldwide opens skies (full liberalization) which would essentially `abolish` the ownership and control principle –the main reason of the existence of alliances- and permit the restructuring the of the airline industry through mergers and acquisitions\(^\text{22}\). It is only the commercial aviation industry that needs to still rely on alternative structures to mergers (i.e.: alliances). This restructuring process will most likely to take place step by step and it is very unlikely that it will be an `overnight` event.

The second scenario draws up a slow and gradual advancement in the regulatory structure of the industry. Airlines will be assumed to form joint ventures with other airlines due to the

opposition of competition authorities of deepening alliance integration. According to the second scenario, the next stage will be the forming of joint ventures between alliances parallel to alliances for the purposes of sourcing, sales and distribution\textsuperscript{23}. From my point of view this option seems to me to be the most probable scenario out of the three proposed possibilities since this solution would best meet the airlines needs.

The third scenario is the so called ’turning back the clock’. This scenario implies a breaking up of alliances due to co-ordination problems and power conflicts between alliance partners, continued government ownerships in airlines and emphasis of national interests\textsuperscript{24}. This scenario can particularly be applicable and relevant in the case of Star, which is already talking about the ’Alliance of the Fifty’ a number that can very easily lead to power conflicts between partners, thus could lead to the breaking up of the alliance.

There will always be carriers who will choose to stay unaligned. The no frills airlines of the world and the full services carriers of the Middle-East (i.e.: Emirates and Virgin Atlantic) are the best examples of unaligned carriers.

Concluding remarks

Over the course of time it became obvious that the present narrow bilateral framework is not supportive when it comes to the needs of air transport enterprises, thus it is in need of urgent replacement. The present protective system of bilateral agreements between countries serves as an impediment rather than a facilitator in today's increasingly competitive environment. Under bilateral agreements, alliances avoid the limitations on foreign ownership and effective control and expand their market excess without the need to obtain additional traffic rights. Nonetheless, the bilateral system continues to restrict the industry from free market operations.

Since it is highly unlikely that the bilateral regime and the restrictions imposed by the ownership and control rules will go through a fundamental change in the immediate future it seems that for airlines, forming alliances will continue to be the only possible way to overcome regulatory challenges and to effectively compete with each other in today’s rough

\textsuperscript{23} Ibid. p. 195
\textsuperscript{24} Ibid p. 195
reality for quite some time. Due to the regulatory burdens the only way for airlines to grow and establish presence in a larger and 'far away' market is by joining one of the global alliances.

From the author's point of view, a multilateral framework would be desirable for the airlines of the world to enable them to expand globally and also to compete globally. Until this new framework is not set up no significant pro-competition changes will take place in the aviation industry. It is submitted that multilateralization is inevitable and will serve as the solution for the challenges the industry is facing. It is remarkable that an industry that is supposed to be the most global industry of all is still tied up by the restrictions of 'ancient' post-war ideas. Unfortunately, these 'outdated' ideas continue to define the existence and operation of this unique industry. We have yet to see whether, once cross-border mergers become possible by the loosening of ownership and control rules, alliances will be replaced by full mergers or not.