Arthur D Little

Viewpoint

Aviation Alliance Strategy

Beyond the global alliance model?

In the context of a challenging macro environment, the global aviation sector is facing unprecedented change due to advances in aircraft technology, disruptive business models and a new generation of digitally enabled passenger. In light of these "hyper-competitive" pressures, Arthur D. Little re-examines the global alliance model and considers the future of cooperative strategy in the aviation sector as the industry enters a new competitive era.

Introduction: The Era of Hyper-Competition

Formed over 15 years ago, at the outset of what Arthur D. Little has described as "the era of hyper-competition", the global airline alliances have proven to be an enduring feature of the global aviation landscape. In a period characterized by growing competition for resources, airlines face multiple pressures, from high capital replacement costs and disruptive "low-cost" business models, to regulatory change, and the challenges and opportunities posed by rapidly evolving technology.

Characteristics of Hyper-Competition

1950 1960 1970 1980 1990 2000 2010 2015 2020 2025

	Era of monopolies	Era of continental competition	Era of hyper-competition
Dominant geo-economic zones	Nations	Larger continental free-trade zones (NAFTA, UE...)	Global megacities
Traffic & ownership rights	National airlines, bilateral agreements, with traffic rights down to airport to airport level	Deregulation at continental level (USA, Europe, India, China...)	ASEAN Opens Skies Global Open Skies
Oil	Abundant & cheap	Uncertain supply and volatile prices	Scarceness and high prices
Aircraft	Long-haul jets	Efficient medium-haul jets and short haul turboprops	Next-generation long-haul jets enabling to tap smaller markets
Wealth & mobility	« Jet set » Airport traffic: from 2% => to 30% of world population	« Mass transportation » Airport traffic : 30% => 80% of world population	« Hybrid and fragmented clients » Airport traffic : 80% => +100% of world population

Faced with these pressures, from the late 1990s onwards the leading full-service airlines (FSAs) were quick to secure membership of one of the three mainstream global alliances – SkyTeam, Star Alliance and Oneworld – which in 2013 accounted for around 54% of total seats flown[1]. The alliances promised many benefits, from enhanced connectivity, to cost savings and a smoother customer experience.

Yet although alliance membership has continued to expand, disruptive change has the potential to alter the pattern of incentives that determine cooperation between airlines. Some of the most prominent changes over the past 15 years include:

- **Consolidation:** although the European market remains fragmented, in North America, the industry has consolidated, which has increased the ability to manage capacity
- **Technology:** mobile and digital technology is reshaping the interfaces between passengers, airlines, airports and third-party providers, empowering the passenger and creating new opportunities for product and service innovation
- **Traffic and Ownership Rights:** from the EU-US OpenSkies agreement to changes in ETOPS legislation, regulatory change continues to facilitate ever-closer connectivity
- **Oil:** sustained fuel price volatility has dramatically reduced airline operating costs, albeit at the expense of capacity discipline in some markets
- **Aircraft:** the launch of next-generation, composite-based jets is transforming the market, especially in long-haul, enabling a new breed of "long-haul, low-cost" carrier
- **Airports:** enhanced hub infrastructure and innovative mobile technologies are transforming the airport experience, enabling more efficient transfer of passengers and bags

All of these changes bring profound implications for the global aviation industry, and it is in this context that we consider the

1 Source: CAPA – Centre for Aviation and OAG, 2013

implications for the global alliance model and assess the future outlook for cooperative strategy in the global aviation sector.

Industry Dynamics: The case for the status quo

The propensity for airlines to enter into cooperative arrangements reflects the characteristics of the global aviation sector, in particular, high demand and supply-side uncertainty, capital intensity and ingrained partner dependence.

Over the years, these arrangements have withstood significant supply and demand-side shocks. Thus, even when step change variations to key input variables like have occurred, these have not been sufficient to upset the balance of incentives that drive airlines to cooperate. To consider the cases of changes to airport capacity and fuel price more closely:

- Hub airport capacity: For airlines to maximize their schedule attractiveness, it is not only total slots, but also *availability of slots at peak times*, that is paramount. Therefore, because capacity allocation is uncertain and hub airport slots remain such a prized commodity, airlines are likely to be better off pooling resources and aligning schedules – which has often been in the form of alliance arrangements.
- Fuel price volatility: The dramatic fall in fuel prices since June 2014 has brought with it challenges and benefits. Although a welcome source of cost pressure relief in the short term (subject to hedging strategy and exchange rate movements), a side-effect can also be excess capacity, driving down average yields and increasing the need to cooperate to mitigate these effects.

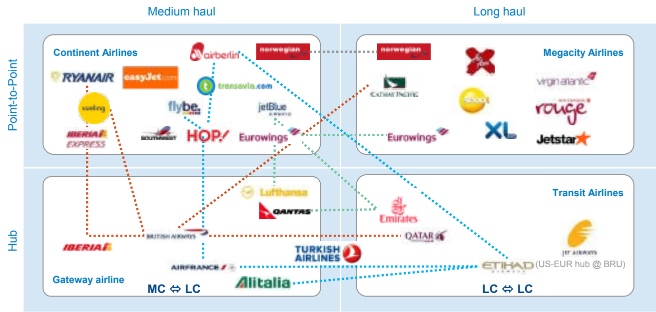
These examples demonstrate the role that alliance arrangements can play in helping airlines avoid a destructive "race to the bottom". Equally, the longevity of the alliance model can be traced to a number of positive benefits, including:

- Airport experience: As the need for passengers to transit through busy hub airports continues, business passengers in particular value the benefits of lounge access and fast-track security, that alliance membership can help to secure.
- Data sharing: From a back-office perspective, alliances can also help airlines by investing in common data centers to facilitate data exchange between alliance partners and enable a more joined-up passenger experience.
- Loyalty schemes: Especially for smaller carriers, the ability to build a compelling "earn and burn" offer, through the ability to accrue and expend miles across multiple carriers, can be particularly important.

New cooperative models

Yet despite its resilience, to what extent can the alliance model continue to weather the transformative changes in competitive mix, that have been witnessed in the era of "hyper-competition"?

Industry-Shaping Role of Transit Airlines



Source: Arthur D. Little analysis

Since the birth of the global alliances, the rapid ascent of the Gulf carriers has redefined the centre of gravity in the global aviation market. Leveraging strategically located hub airports and modern fleets, these carriers have developed industry-shaping business models in which, as "transit airlines", they play a leading role in connecting the world's major aviation markets.

As the below case studies show, changes in the competitive forces that define the global aviation market are forcing many FSAs to re-evaluate their cooperative strategies and adopt alternative cooperative models:

Case Study: Qantas-Emirates non-equity joint venture

In 2012, despite being one of the founding members of Oneworld, Qantas entered into an extensive 10-year commercial agreement with Emirates, a major non-affiliated airline.

The deal is underpinned by integrated network collaboration, including the relocation of Qantas' European hub from Singapore to Dubai; coordinated pricing, sales and scheduling; and a benefit-sharing model. For Qantas, the deal provides an alternative way to enhance performance, beyond the confines of the traditional alliance model.

Case Study: Delta-Virgin Atlantic equity joint venture

In 2014 Delta, already a member of SkyTeam, entered into an equity joint venture with Virgin Atlantic Airlines (VAA) on transatlantic routes, taking a 49% equity stake in the airline.

Faced with airport capacity constraints at Heathrow, the JV has allowed the airlines to enhance their collective offering to the transatlantic market. The tie-up is also consistent with VAA's alliance strategy, in which it has historically entered into bilateral partnerships with a number of airlines outside of global alliances.

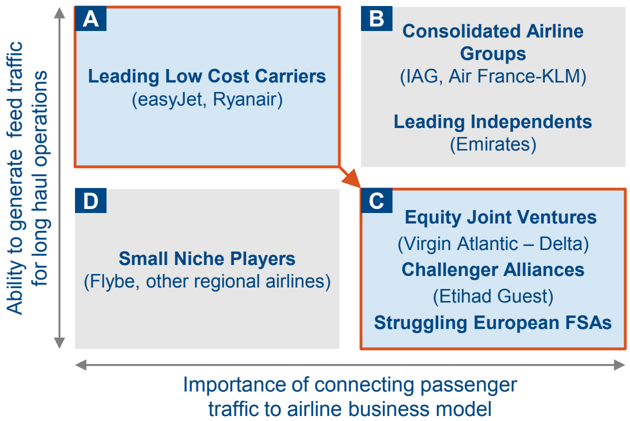
As these cases highlight, airline alliance strategy is not a binary choice between maintaining full operational independence and global alliance membership. Increasingly, the pressures of hyper-competition are resulting in the world's FSAs transitioning to a more proactive form of alliance strategy, in which multiple types of inter-industry cooperation may be combined to maximize the total potential benefits for any one player.

Cooperation between Different "Species"?

However, the scope for new cooperative possibilities is by no means limited to the FSAs.

On the contrary, even though connecting passenger traffic is not a central pillar of the low cost point-to-point business model, as a result of their success in driving a fundamental shift in traffic ownership, the LCCs has come to represent a major source of *potential* feed traffic themselves. The combination of traffic-hungry FSA long-haul networks and LCC networks with industry-leading load factors presents alternative cooperative possibilities, for example between leading LCCs and FSAs with more limited ability to generate their own feed traffic:

Cooperation between Airline Clusters (selected airline examples)



Barriers to Cooperation: A Glass Ceiling?

Of course, the potential for cooperation between low-cost and full-service carriers is not a new observation. However, whereas in the past the barriers to closer FSA-LCC cooperation appeared insurmountable, today developments in operating model, brand and product convergence, and distribution strategy suggest that these long-standing barriers may at last be starting to ease.

Operational Compatibility: New operating models, involving the sharing of transfer risk between airports and airlines, may make it easier for LCCs to align selected "feeder" routes with FSA partner airlines without sacrificing the operational simplicity of the LCC business model.

Brand and Product Compatibility: Incremental convergence of product and service offerings has reduced the FSA-LCC divide. Customer priorities and expectations have also changed, with considerations of on-time performance (OTP) and value for money growing in importance of brand loyalty and comfort as leading determinants of airline choice.

Distribution Compatibility: LCCs have now come to the GDS table, to increase their share of high-yielding business passengers. While the fact that LCCs do not use the IATA Billing and Settlement Plan (BSP) remains a barrier to future LCC-FSA cooperation (because of the requirement for airlines to make full use of the BSP for interlining to be possible), there are signs that the balance of distributive power may be changing:

- IATA's New Distribution Capability (NDC) is driving industry-wide change by defining a new communication code and standards between airlines and channel partners that could reduce the traditional reliance on the GDS model.
- Aggregator platforms such as Travel Fusion and Multicom have the potential to transform how airlines interact with customers, by offering airlines similar services to those currently provided by the major GDSs at much lower cost.

From Hyper-Competition to Hyper-Consolidation

If the alliance model has proven its ability to coexist alongside other cooperative vehicles during the era of hyper-competition, what will aviation sector players need to do to optimize cooperative strategies in the new era of "hyper-consolidation"?

In this new era, intense consolidation will drive a far more dynamic form of alliance strategy. The focus will shift from the current *airline-centric* model to a broader concept of *aviation alliance* strategy, that embraces multiple players across the value chain. Existing barriers to cooperation may be overcome, resulting in ever-closer relationships, including between airlines of different "species".

Faced with this new competitive reality, there are four elements that airlines and their partners should consider when seeking to assess the outlook for cooperative strategy and determine where effort and resources should be concentrated:

Product and service:

- The use of digital technology to transform the product offerings will become a critical source of competitive advantage as airlines strive to offer genuinely tailored solutions rather than the traditional standard offerings dictated by class of travel or status type.
- Airlines will need to look beyond traditional frequent-flyer programs and find new ways to differentiate their loyalty offers, as well as address the less familiar needs of a new generation of technology-savvy travelers – not just those elements of value that appealed to yesterday's core customer.

Network and operations:

- As long-haul and short-haul markets are ceded to FSA and LCC carriers, respectively, the practical challenges of direct FSA-LCC interfaces will be outweighed by the potential for new value creation.

- The emergence of viable long-haul low-cost operators brings further disruptive potential to core FSA markets and the alliance model. If these new carriers are successful in replicating the low-cost model in long-haul point-to-point markets, we may witness the emergence of a new generation of long-haul low-cost traveler, whose perceptions of value are fundamentally different to present-day offerings.
- As the take-up of the next generation of wide-body jets gathers pace, more and more airlines will seek to exploit the ability to serve new long-haul city pairs with fuel-efficient aircraft, bypassing global hubs and many of the connecting services that global alliances have traditionally offered.

Distribution and customer:

- The most successful airlines will be those that effectively combine a simple upfront product offering with a range of options so these can be tailored to the needs of individuals.
- Distribution strategy will become the new competitive battleground. Relationships with airlines and third-party channel providers will grow in importance as the quest to increase channel power based on new industry standards and retain value creation intensifies.
- Ownership of passenger data will become a key source of competitive advantage, with those retaining control better able to conduct targeted marketing and embed the customer relationship.

Conclusion

The global alliances have played a central role in helping airlines mitigate the negative impacts of hyper-competition. Nonetheless, during this period, we have also seen the emergence of a multi-faceted form of alliance strategy that embraces a variety of cooperative vehicles. Cooperation has evolved from non-equity models, including the alliances, to other, often equity-based platforms.

While the alliances have not failed, fulfilling the specific need to help airlines manage overcapacity, the diversification of airline alliance strategy nonetheless suggests that the needs of airlines and passengers have changed. In a market where the costs of market entry and overcapacity are extreme, this is unlikely to mean an end to the alliance model; indeed, experience demonstrates that the choice between alliance membership and other forms of cooperation is not mutually exclusive.

Nevertheless, the alliance model has perhaps reached its high water mark, paving the way for the continued emergence of a more multifaceted form of cooperative strategy in the future.

Contacts

Kurt Baes
Belgium
baes.kurt@adlittle.com

Yusuke Harada
Japan
harada.yusuke@adlittle.com

Ralf Baron
Central Europe
baron.ralf@adlittle.com

Thomas Kuruvilla
Middle East
kuruvilla.thomas@adlittle.com

Antoine Doyon
China
doyon.antoine@adlittle.com

Klas Anderlind
Nordics
anderlind.klas@adlittle.com

Mathieu Blondel
France
blondel.mathieu@adlittle.com

Jésus Portal
Spain
portal.jesus@adlittle.com

Saverio Caldani
Italy
caldani.saverio@adlittle.com

Russell Pell
UK, Hong Kong
pell.russell@adlittle.com

Authors

Russell Pell, Mathieu Blondel, Andrew Smith

Arthur D. Little

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