Where Is International Air Transport Going?

A Presentation by
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During the past decade, the international, bilateral aviation regime of bygone days began to collapse, undermined by a new system of cost-and-revenue economics driven by U.S. hub carriers. The Europeans reacted to this change by sharply restricting American aviation services, in order to provide themselves time for realignment. Consequently, many European airlines have structured for themselves an environment that ensures their own survival and, at the same time, imposes de facto limitations upon the ability of U.S. carriers to compete on their turf.

Before the emergence of the new environment, characterized by code-sharing and alliances, single-carrier networks were the rule. Because U.S. carriers enjoyed extensive rights to international routes, they were able to create small hubs not only in the United States but also overseas. Most Asian and European airlines had established extensive networks, usually in a single major city, but they had not yet "hubbed" their operations. That is to say, their flights were not scheduled to create connections.

As a consequence, U.S. carriers enjoyed a major advantage in the marketplace. If one wanted to travel from New York to Budapest, the only choice was Pan Am, unless one wanted to spend the night in a European city en route. This lack of choice kept prices artificially high and allowed American companies to run overseas hubs profitably, despite cost and operational inefficiencies.

In the 1990s, however, the world began to change. KLM, which had already created the first true, European hub, began to expand. Essentially, it merged its transatlantic operations with Northwest Airlines, creating the first single network to link the entire United States with all of Europe and with much of Africa and the Middle East. Then Lufthansa and Air France rescheduled their flights to create true, connecting hubs at Frankfurt and Paris respectively.

Consequently, instead of being faced with the single choice of Delta (which had replaced Pan Am), the air traveler could choose from among several carriers. This led to a dramatic price drop in European markets that had limited nonstop service, or none at all, to the United States. Despite having significantly lower unit-costs than European airlines, U.S. carriers could no longer operate offshore hubs profitably.

The reason had to do with issues of both costs and revenues. The U.S. offshore hubs were operationally inefficient. Generally, there were two waves of flights each day. A first wave from the United States would converge in some European city (usually either Frankfurt or Paris) and then continue to other European or Middle Eastern destinations. A
second wave would then operate in the reverse. European carriers, however, were able to mount multiple connecting waves throughout the day, utilizing facilities, equipment and personnel more efficiently, just as U.S. carriers do at their hubs, where ten-to-twelve daily waves are the norm. Accordingly, despite generally higher unit-costs, the Europeans enjoy an operational economy of scale that created a cost structure U.S. companies could not match at their offshore hubs.

The most important factor, however, was revenue related. Previously, for example, almost everyone traveling from the United States to Hungary or Poland used a U.S. carrier. With European hub carriers targeting those markets, and with the entry of Hungarian and Polish carriers into the American market, the volume of traffic was spread out and prices naturally declined.

European hub operators also had a basic advantage over U.S. offshore operators in that, once they started hubbing, they were able to combine multiple traffic flows to which U.S. carriers simply did not have access. For example, in Frankfurt, Delta connected eight nonstop flights from American cities to eight different cities in Eastern Europe and Asia. However, Lufthansa’s Frankfurt hub can connect forty-plus cities in the Americas and Western Europe with more than forty cities in Eastern Europe, Africa, the Middle East and Asia. There was simply no way that Delta could compete.

Having seen the U.S. airline industry consolidate into fortress hubs, which enjoy the extreme cost and revenue efficiencies described above, the Europeans followed suit. Because U.S. companies have been restricted by aviation agreements from flying between European cities, it has been impossible for them to offer competitive prices or services at their offshore hubs. As a result, U.S. carriers have been retreating from their offshore hubs. Delta has abandoned its Frankfurt hub, and TWA and United have both dismantled their hubs in Paris. A new era of alliances and code-sharing (franchising) has arrived.

The old era of fifth-freedom rights has slipped away because the U.S. industry failed to recognize changes in the competitive environment and to make the necessary adjustments. This is an opportunity lost. For years, many U.S. carriers sought to build global networks through the expansion of core operations overseas. What they failed to do, however, was to convince the U.S. government to shift the focus of its negotiations in that direction. Such a shift might have allowed U.S. companies to build true hubs overseas before the Europeans got their act together. Combined with lower operating costs, those hub arrangements would have allowed American carriers to tap high-growth
international markets without the need for alliances. With that path blocked, the only alternative for American companies has been the system of alliances with their European competitors.

Given the missed opportunity to build overseas hubs, and given the state of the current economic environment, it seems appropriate to ask where the industry should now be headed.

One pressing question, in particular, is what the industry intends to do to get costs under control. While it seems likely that some European companies will soon catch up with their U.S. competitors in the areas of capital, airplanes and facilities, it seems highly unlikely that labor costs will reach competitive levels, so a continuing imbalance in costs is a reasonable expectation. Even within Europe, there are wide differences in cost structures, meaning that some governments today must still subsidize their national carriers. Withdrawal of those subsidies may cause some casualties and force consolidation, much like what has occurred in the United States, and that will actually lay the foundation for a more efficient and vibrant industry.

Any effort to offset higher cost structures, of course, will make the revenue equation even more important. Here, efficient management of a network becomes critical in the global environment. Alliances may harmonize resources, but they do not necessarily allocate them efficiently. In the Lufthansa/SAS alliance, for example, the two partners are operating parallel services in competition with each other over Copenhagen and Frankfurt, rather than reallocating their resources to create complimentary hubs and broaden their schedule offerings.

If revenue leverage is to be gained, it will ultimately have to come from the creation of a common brand name, the unification of frequent flier programs, and a yield management system that controls all networks within an alliance as if they were one. Although such arrangements will occasionally enhance the profits of one partner at the expense of another, it will increase the profitability of the overall alliance.

This type of tradeoff is extremely difficult when various corporations in a common alliance have fundamentally divergent interests (e.g., control of decision-making, the maximization of home-country profits, employment, and spending.) Nevertheless, if the aviation industry is going to continue growing, it must evolve into a true market entity. If both cost and revenue efficiencies are to be achieved, there must be single-source decision-making by single, corporate entities.

More importantly, even a surface examination of the issue reveals that
global consolidation is vital if U.S. airline companies are to remain financially viable and dominant in the marketplace.

If the industry is to evolve along the lines described here, however, serious questions will have to be addressed regarding the overall strategic direction of U.S. carriers. Additionally, such changes will require a major shift in the government’s policy focus. Otherwise, yet another opportunity may be lost.

Unfortunately, the current bilateral aviation environment, where the citizenship of the airline operator forms a sort of national identity, seems to preclude any movement in the direction of cross-border ownership consolidation. As a consequence, the consumer continues to be faced with inconsistent service and broad price disparities, while the value of the enterprise to the investment community is diminished.

The major sticking point is sovereignty, but the issue of sovereignty is already beginning to ebb with each passing day. National flag airlines have been rapidly going out of business and will continue to do so. It will take a major shift in mindset, but – even as Kansas City learned that it can thrive without a local airline hub – many nations will surely come to learn that they are better off having frequent service offered by several competing airlines than paying for an inefficient national carrier through higher prices, frequently poor service and large subsidies.

For their part, U.S. carriers face the difficulty of convincing other nations that sovereignty is no longer important and that globally owned corporations offer the best chance for continued strength in the airline industry. As to the first point, the British, the Canadians, the Dutch, the Germans and the Scandinavians – a highly influential block of nations – are already moving in this direction. The present challenge is to bring other individual European nations and, ultimately, the entire European Union into the economic fold. Once North America and Europe can agree to relax ownership barriers, agreements with each nation could be negotiated, removing barriers to ownership and entry, and making the way clear for the industry to consolidate globally. Given the importance of the U.S. and European markets, there will likely be few national holdouts from such an aviation regime.

Consolidation requires capital, of course. On a worldwide basis, the airline industry also desperately needs capital for privatization and investment. With a few exceptions, the only airlines having such capital resources today are U.S.-owned. There is an excellent opportunity here
to use the financial strength of the American carriers to guarantee that the United States has a guiding voice in the direction of the industry as a whole.

Of course, it is to be expected that the shifts in ownership being discussed here are likely to worry organized labor, even though such concerns have no ground in reality. Flights within each nation would still have to be operated by home-country nationals, just as the auto plant in Thailand uses Thai workers instead of American or Japanese. Flights between nations would be operated much as they are today, using many nationalities in a cost-effective manner. While there will be job losses in certain locations, globalization of the industry, as a whole, will lower costs, reduce prices, increase demand and create more jobs in the end. More specifically, those nations enjoying high productivity and efficient costs, which includes the United States, are likely to add more jobs.

With all this said, what is needed for the industry to move forward? A good start would be to have a few more airline CEOs follow the lead of Bob Ayling and Bob Crandall and speak up about the ownership and control issues that make sense for their companies in this new global era.

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