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AN INDUSTRY PERSPECTIVE

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What I want to talk about is the changing structure of the air transport industry not over the past 50 years, but looking ahead. What I shall do is address this under three headings: First, what is happening, at least from the point-of-view of an integrated long-haul carrier based in Europe. Second, why are these changes happening, and what is driving the process of structural change in our industry. Last, how should public policy react?

First, what is happening? Consider first the US market which is both the largest and, in a regulatory sense, the most mature market in that it has been deregulated for longer than others. But maturity does not imply stability. Since the 1970s there has been a rash of start-ups, a wave of bankruptcies and consolidations. It has not been a stable market structure at all.

Is it stable today? Well that is anybody's guess, but from our perspective, there appears to be a three tier market structure in the US. There are the three large integrated domestic-international carriers; American, United and Delta. All are profitable, though possibly with over hanging cost problems that will reemerge when the economy turns down again. There are then four intermediate carriers, USAir, TWA, Northwest and Continental, occupying what is probably a rather precarious ledge of being an intermediate carrier in the US market. This ledge probably is not a stable or large enough one for four carriers to occupy for the long term future. Then there are many regional carriers and low cost, no frills operators, some profitable and some not. The market share of those carriers has yo-yoed over the last 10 years, between 10% and 21%. Our view is that it probably will not exceed 15% on average over the next 10 years, and it will probably continue to be a story of new entrants, exits and consolidations.

There is still some evidence of over capacity in the U.S. market. Even the profitable players have lower seat factors than British Airways, even adjusted for stage length. The question is, why, in a mature and competitive market, during the 6th year of fairly strong economic growth, is there still over capacity? The over capacity may be due in part to the ease of market entry; the high price elasticity of

demand -- particularly the high cross price elasticity in our industry -- and the supply discontinuities. In this regard, supply discontinuities refer to the fact that planes come in certain sizes such that when one frequency is added to a route, capacity is often increased by 20-30%. The discontinuities are at the route level, not at the firm level. The over capacity is also due in part to selling a perishable product. That is, if a seat is not sold before the plane departs, the revenue from it is lost forever. This encourages deep price discounting.

Given these characteristics, there is a very real question as to whether the air transport market will reach sustainable equilibrium positions. There is not a lot of evidence of that in the US case. If not, if the industry is doomed to structural turbulence, then this raises some quite different regulatory issues than if it is a market which is always headed for equilibrium.

In Europe, the industry structure has four segments. First, there is a small segment of profitable, integrated carriers. This segment includes British Airways, KLM, Lufthansa and SAS, all of whom over the medium to long term have been profitable, although not every carrier in every year. These carriers have cost and revenue structures, and marketing strategies that are in some sort of sustainable alignment. Second, there are a large number of loss-makers, including Iberia, Air France, Alitalia, Sabena and Swiss Air. Certainly from a financial point of view, being a loss-maker year after year is not a sustainable position, even with government subsidies. In Europe the Commission is imposing more discipline on state subsidies in an attempt to replicate the effect of private shareholders. The days of European carriers operating without any budget constraints are all but over.

Third, there is a small but growing number of no frills carriers that mostly operate inside the domestic European market. This segment includes Ryan Air, Debonair and EasyJet in the U.K. It includes Deutsch BA in Germany, and within France TAT and Air Liberté. The low frill carriers are making gains domestically, but it is difficult to foresee them making significant gains across borders in Europe. Part of the reason is that there is not as much potential for market stimulation across European borders, as in the US market. Most people living in Britain don't have relatives in Italy or Switzerland, whereas many people who live in New York do have relatives who live in California or Chicago. The so-called visiting friends and relatives (VFR) market is much smaller intra-Europe than it is intra Canada or the United States. There are also issues on the cost side in Europe, which make any carrier higher cost predominantly because of the social overhead cost of labour and, to some extent, airport related costs.

Finally, a fourth segment of market structure in Europe is the charter market. This segment accounts for over 30% of European travel; that is all flights that touch Europe or are intra-European, and it includes both long and short-haul. The charter market has been shrinking as a share of the total, and it will probably continue to shrink. As the integrated carriers become more efficient and more able to fill their seats, and use yield management in an effective way, as has been the case in the US, they will gain and make inroads on the charter market. But for the next 5-10 years the charter airlines will remain an important competitive force.

In Europe, the structure of the industry is also unstable, but I think it is not going to change rapidly, partly because of the existence of subsidies. I was interested to

hear Marc Gaudry talk about the way the French decision on TGV funding had been made, if the amount of money the French poured into Air France in the last three years had instead been spent buying BA shares, we would be 2/3 owned by the French Government today. At least so far, it would have been a better investment for them! In any case there are still political and regulatory barriers to consolidation in Europe, and without consolidation there will not be significant changes in the market structure.

In the Asia Pacific region, the situation is again different. That is a region of the world where demand is growing very rapidly. At the same time the airport infrastructures as well as the number of planes and carriers are also growing very rapidly. It is reminiscent of the situation in North America or Europe back in the 1960s, when it was very much a high growth industry and where there were not as many constraints on the infrastructure side as there are today. Since over capacity is not evident in the Asia-Pacific, there is very little interest in the intra-Asian alliances that one otherwise might expect to see. There is also not a great deal of interest in extra-Asian alliances, with the exception of Qantas whose domestic market, as you have already heard yesterday from Mr. Wolf, is similar to the deregulated US/UK.

Finally, if we do lift our eyes above this regional level, and think about the kinds of structural changes in the industry that are happening across regions, the most significant development is, of course, the cross regional alliances that are being built. They often include an intra-European element. The Lufthansa-United alliance, for example, is a cross regional alliance which has full anti-trust immunity as well as an intra-European element (Lufthansa-SAS). The regional carrier, British Midlands, is also 40% owned by SAS. Our own alliance with American Airlines, which is being looked at by three sets of regulators at the moment, includes Qantas as the Asian component. The Lufthansa-United relationship is blessed with anti-trust immunity, and therefore is able to do many more things together than we could do with American Airlines without that immunity. The KLM-Northwest alliance is of course the 3rd one. It does have anti-trust immunity, but does not have an Asian partner at the moment. Then there is the Swiss Air-Sabena combination in Europe, with Delta as the American partner, again with anti-trust immunity, and Singapore Airlines as the Asian partner.

It is important to remember that although alliances are forming, the history so far is that these are not easy partnerships. They have been difficult to cement and to implement. The difficulty relates mainly to the regulatory structure. I can compare the situation to that in the oil industry, from my days working at Shell. There are lots of strategic alliances, both in the chemical industry and in developing major oil fields around the world. It was almost always the case, at least if it was a big, risky investment, that a joint venture would be formed to share the risks and the rewards. When you have a joint venture and a shareholding pool, then it is much easier to develop common policies that benefit both partners. If there is no pooled share holding, as there isn't in most of the airline alliances, at the end of the day, the directors of those two companies are legally and rightly responsible to their own shareholders. That it is why it is fundamentally very difficult to build deep alliances in our industry. The question one needs to ask is why are people trying it at all?

The industry, at least as I see it, is perhaps midway through a fundamental transition from having national monopolies, to having global competitors. There are two parts to that; one is the national to global, and the other is monopoly to competition.

In regard to the national to global part, what is happening in the airline industry is only an example of what is happening in many many industries, particularly networked industries, such as computer software and telecommunications. The motivations may vary, but in these industries it is more often about achieving network economies than simple cost-reduction or scale economies.

Professor Sickles suggested that alliances are being driven by cost savings. This may be true on the domestic front but recent data indicates that for British Airways unit cost savings are not significant when benchmarked against American carriers, correcting for sector length. In our discussions with American Airlines leading up to the our alliance with them, it became clear that in some areas they are able to operate at lower costs than we, and in other areas we operate at a lower cost than they. We would expect this result because we have different patterns of capital and labour input cost.

If the rational is not cost savings, what about economies of scale? Academics have been telling us for years that once you get past the level of about 15 or 20 airplanes in your network, there are no firm-level scale economies. What drives alliances is network economies and it is demand-side externalities that are the main justification. Customers prefer to connect on the same carrier, if at all possible, or if not, then connect on a code-share. When looking at how customers book through CRS systems, it is clear that even when CRS systems have all bias eliminated, customers prefer connections on the same or code-share linked carriers.

There are also network economies on the supply side. Connections with a partner enable you to build hubs in different parts of the world to connect the two networks at third points around the world. There is some evidence now in the US market that perhaps hubbing has gone too far in the sense that there is now scope for new entrants to bypass hubs and build point to point traffic. The European and Asian carriers' situation is that hubbing has not gone far enough to reap its full benefits. We did an analysis to compare inter-continental hubs in the US and Europe. An intercontinental hub was defined as an airport that had at least 20 intercontinental destinations offered from it. Europe has 22 such intercontinental hubs – airports from which you can fly to at least 20 different places beyond Europe. The US, with a similar size and wealth as Europe, has only six such hubs. These six intercontinental hubs are in five cities, with New York having two of them. So, hubbing has occurred in the deregulated US with a very different result from that in Europe. I do not think Europe will reach the same point because population distribution is different, among other things. But those benefits behind hubbing and the passenger preference for code share or single brand on the whole route are the things which are driving this industry to look at global market places, not just at a national market place.

Does global mean monopoly? Not if we follow the pattern of other industries. Consolidation occurs when liberalization comes, and then greater competition among stronger players. For example, many countries had their own auto industry.

There was consolidation, first at the national level, then at the regional level. Today, the largest five auto companies account for 45% of the world market, and yet very few people, economists included, would claim there is monopoly power in the auto industry or that customers do not have sufficient choice. I should also say that those top five car companies have alliances among themselves. General Motors and Toyota are the top two and they have a strategic alliance. So, deregulation and globalization lead both to consolidation and to greater competition. It is competition across alliances, among alliances, with new entrants on short-haul routes, on long haul-routes, and on different market niches around the pattern of one's network.

That brings me to my final topic which is the public policy issues that these changes in the structure of the industry raise. In my mind, the public policy issues really boil down to one issue in the long run -- competition policy. There are certainly other elements, other aspects in which governments will and should remain involved. On the safety side, for example, I would never suggest that governments withdraw. On bilateral route negotiations, we heard from Mr. Michalski this morning, about where he sees that going, and as a member of his committee I firmly subscribe to his view. Slot allocation is also a very big issue in Europe. All of these have a different order of magnitude in terms of the structure of the industry, the benefits to consumers and the economic efficiency of producers in the industry. They are all second order issues compared to competition.

The key competition question for the policy maker is: "Under what circumstances does greater consolidation lead to inefficient market outcomes?" We have many academics and researchers in this audience. I do not suggest that people do research on whether deregulation will lead to consolidation, as I think it almost certainly will. But the analysis should not stop there. Rather, one must trace the steps in the argument from liberalization leading to consolidation, at least at hubs, to the share of operations at individual hubs by certain carriers. That itself provides greater passenger benefit, because the connecting time through the hub becomes less if a carrier builds up its operations there. It probably also provides lower operating costs. That could indicate that prices would go up or down at that hub depending on whether the benefits to the customer, and the customer's willingness to pay, offsets or does not offset the potential for lower costs.

Competition authorities are concerned only if prices go up. So, if prices go up it is still necessary to disentangle, statistically speaking, how much of that increased benefit reflects the customer's willingness to pay for something that was not there before the airport became a hub, and how much of that increase in price is due to the simple fact that the infrastructure is constrained. We all know as economists that when you have constraints, prices often do rise, depending on the substitute available. I would particularly like to see research on a comparison of what happens, from a competitive point of view, in cities that have more than one airport. The Southwest strategy and those of other new entry carriers, is not to set up at large constrained hubs but, rather, to offer something which is a substitute from another airport. The reason I am particularly interested in such research, of course, is because London has four airports: Heathrow, Gatwick, Stansted and Luton. The low cost carriers that operate in London are not setting up at Heathrow, not because

British Airways would drive them out of business, but because of the costs and the unavailability of slots. It would not be sensible from an air policy point of view either to have tiny planes fly in and out of Heathrow. The competitive scene in London, with its four airports, (five, if you count City Airport) is different compared from other cities in Europe which have a single airport. There must be interesting data sets that one could look at in the US market on multiple airport cities. I think there is a whole range of areas where transport research could help us answer these key competition policy issues.

Having discovered what conditions there are that might, do, or have, led to anti-competitive outcomes of consolidation, then the second question is, "Is there anything peculiar about those conditions to the air transport industry?" If so, we need to continue to regulate consolidation in air transport differently. But if not, we need to subject the airlines and their activities to exactly the same anti-trust surveillance that other industries have to face. In my own view, and I do not claim to speak for the industry, this kind of shift by government, from transport policy to a rather sophisticated view of competition policy, drawing upon evidence that is available from economists and others, is the logical regulatory counterpart of the shift in the air transport industry from public to private ownership. I think that those two shifts need to go hand in hand in the future.