

11-2013

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Scholarly Commons Citation

Friedenjohn, D. (2013). Balance and Alliance. *Air Transport World*, (). Retrieved from <https://commons.erau.edu/db-aeronautical-science/2>

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Balance and Alliance

DOJ's lawsuit against the AA-US Airways merger imposes an unanticipated and misguided delay in the US airline industry's long desired transformation. Daniel Friedenjohn

The US airline industry was nearing the completion of a major transformation that would allow it to become more attractive to the investment community and more stable for its employees and other stakeholders. That plan, however, may be in jeopardy now that the US Dept. of Justice has brought a suit, to be heard in court Nov. 25, to block the merger between American Airlines and US Airways.

The Civil Aeronautics Board relinquished control over domestic routes in 1981, and airfares two years later. US airline deregulation, as predicted by many economists during the 1970s, became a laboratory for a countless number of startup carriers seeking to become the next big airline. Often times, these new (and at times even the established) airlines flooded the markets with seats they were willing to sell at levels below the cost of operating the service. In addition, some new entrants simply grew too fast (remember People Express Airlines?)

The policy has largely favored consumers at the expense of the carriers on which they fly. The financial challenges that have plagued the US industry during 30-plus years of deregulation can certainly lead

one to conclude that the industry may be healthier with fewer network carriers.

Former American Airlines CEO Robert Crandall opposed the Justice Dept.'s approval of both the Delta Air Lines-Northwest Airlines and the Continental Airlines-United Airlines mergers. Recently, he told the *Dallas Morning News* that the DOJ should not have approved those mergers because those carriers were "big enough to realize the benefits of scale." Crandall added the government should have rejected further consolidation among the large network carriers to "assure appropriate levels of competition." He now believes, however, that the merger of the company he once headed with US Airways is necessary so that the industry can realize a "competitive equilibrium." Crandall fears that if DOJ prevails in its case against American and US Airways, neither carrier will be sufficiently large enough to compete with Delta and United.

Crandall may be correct in asserting that both American and US Airways may be in trouble if they don't prevail at trial. An article in the *Harvard Business Review* titled "The Consolidation Curve," suggests that all industries, including airlines, start out fragmented and pursue a path of consolidation. Authors Graeme K. Deans, Fritz Kroeger and Stefan Zeisel stated that once an industry is deregulated, it moves through four stages: open-

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ing, scale, focus, and balance and alliance. When this article was published 11 years ago, the authors described the airline sector as falling under stage 2, or scale cat-

egory, where the focus of the "major players begin to emerge, buying up competitors and forming empires." American Airlines merged with TWA in 2001 and America West and US Airways merged in 2005.

In the last five years, the industry has transitioned to stage 3, the focus phase, where "the goal is to emerge as one of a small number of global industry power-houses." DOJ has approved three airline mergers: Delta and Northwest, Continental and United, and most recently AirTran and Southwest Airlines. According to the Bureau of Transportation Statistics (BTS), these three larger carriers carry about 50% of the domestic traffic when measured by revenue passenger miles.

The industry may be getting closer to reaching the final stage, balance and alliance. In this phase, the "top three companies claim as much as 70% to 90% of the market."

According to the US government watchdog GAO, if the American-US Airways merger prevails, the newly formed carrier will become the largest US carrier. This would mean that the US market would have four large players and a handful of smaller carriers that continue to grow.

Even if you don't subscribe to that article's premise, there are

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other reasons why a “competitive equilibrium” may be best for the airline industry. Fuel represents about 35% of large carriers’ operating expenses according to Airlines for America (A4A). A4A has reported that the average portion of airfare needed to cover fuel expenses increased by over 22 percentage points between 2000 and 2012. The average spot price for jet fuel increased 42% during the 2010-2012 period. Last year, the industry spent over \$50 billion in fuel.

In the highly competitive domestic market, most carriers have had a difficult time finding ways to generate revenue that keep up with rising operating costs. According to the US Bureau of Transportation Statistics (BTS), inflation-adjusted fares declined 18.1% from 2000 to 2013 (first quarter). More recently, the average domestic airfare for the first quarter of 2013



during the last 20 years. During the past 12 years, United, US Airways, Delta, Northwest, and most recently, American Airlines, have sought to reorganize under Chapter 11 bankruptcy protection.

“THERE ARE OTHER REASONS WHY A ‘COMPETITIVE EQUILIBRIUM’ MAY BE BEST FOR THE AIRLINE INDUSTRY.”

saw a slight year-over-year increase of only 0.1%. Airfares, even when ancillary revenue such as baggage fees and reservation changes are taken into account, have failed to keep up with consumer price index, which increased 36% during this same period.

With rising costs and lagging revenue production, carriers have already applied different strategies to deal with challenging operating environments. Each so-called legacy carrier—except Southwest Airlines and Alaska Airlines—has filed for bankruptcy at least once

Carriers have reduced capacity in the domestic market and more recently have been fairly restrained in adding capacity. In 2004, the industry was flying 6% more capacity, as measured by available seat miles (ASMs), than it did in 2012 in the domestic market.

The large network carriers, meanwhile, have sought to replace the reduced domestic capacity with more international flying. According to the BTS, the US network carriers fly over 30% of their ASMs on international routes. In 2004, 32% of American’s capacity

was placed on international routes. In 2012, it was 41%.

These growth opportunities have been brought about in part due to efforts by the federal government to secure access to new markets abroad. Since 1992, the US has pursued a policy of negotiating new air service agreements that create liberalized environments for US carriers to launch service to other countries without governmental interference. In a little over 20 years, the US has negotiated over 100 agreements with important aviation markets.

These Open Skies agreements have played a meaningful role in helping some of the large network carriers find opportunities outside the US. Furthermore, because these agreements do not restrict competitors from offering new or additional service in the marketplace, US carriers, subject to approval from DOT and other competition authorities, have been given the opportunity to enter into more cooperative relationships such as codesharing and joint venture relationships.

The important changes that the industry has made over the past few years—through consolidation, restructuring and capacity discipline—can lead the industry to a new era. Since the US airline industry was deregulated over 30 years ago, the federal government has never brought a case seeking to block an airline merger. Indeed, the government is not required to approve the American-US Airways merger simply because it approved the last three airline mergers.

Given the meaningful changes that have taken place, however, it would be a shame if these carriers were denied the opportunity to complete an important step that can truly help transform the industry.

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