



**Publication Alert January 2007 –  
Airline consolidation and government policy: myth and reality**

**It is often argued that the airline industry would be better off with fewer and bigger airlines and that there is a strong correlation between size and efficiency throughout aviation. Some airline consolidation is both inevitable and critical to improve the industry's economic health.**

**Observers often speak about a 'natural' lifecycle, whereby a period of new entry and expansion, competitive turmoil and market maturity, is followed by shakeout and consolidation. Airline consolidation advocates imply that active encouragement of consolidation would provide a major boost to the longer-term financial strength of the industry.**

**However, most airline mergers that have been seriously proposed or implemented in recent decades have failed to provide meaningful returns for investors and have failed to improve the industry-wide allocation of capital. Mergers are categorized as primarily "efficiency/synergy", "quasi-restructuring", or "not sensible". Mergers are only a small part of the industry, the number of airlines has been steadily expanding, and the major forces (market liberalization and economic innovation) that drove this expansion are likely to continue.**

**The 'optimal number of airlines' should be driven by competitive economics and will always be subject to change; over the past 25 years these market forces have dictated more airlines not fewer. The biggest problem are the barriers to exit that protect hopeless incumbents from needed restructuring and block opportunities for more efficient, better run airlines.**

**So, arguments that governments ought to actively intervene to force major consolidation cannot be defended. Governments can either decide to leave the aviation business, so that markets can allocate resources and it would not care if there are a larger or smaller number of airlines, or the EC's new objective can be to engineer and to establish a radically new industry structure based on extensive collusion between large intercontinental carriers.**

**Consolidation and mergers in the US**

**In the US we can distinguish two types of airlines: regional and mainline. When the industry was deregulated in 1976, there were nearly 150 regional airlines. Only half of that remain today. The regional sector has been steadily shrinking in numbers for three decades, mainly due to an overall decline of large domestic hubs, reduced economic leverage with their mainline partners and the declining attractiveness of short-haul flights in a more security-intensive era.**

In the US mainline sector we can see that a great deal of “consolidation” of weak/inefficient airlines can occur even when the total number of carriers rises or remains steady. After deregulation the sector counted 48 carriers, shrank to 31, grew to 40 in the early 90s and has contracted back to 30 now.

In the last decade, only two mergers between large US airlines have taken place. These were the American Airlines – TWA merger in 2001 and the America West – USAirways in 2005. None of them was really successful. As mentioned earlier, three types of merger can take place. The major obstacle for ‘quasi-restructuring’ deals is the way bankruptcy judges have handled bankruptcy cases. They give incumbent airline management nearly complete, open-ended control over the reorganization process, despite management’s role in driving these airlines into bankruptcy in the first place.

The arguments against any new US ‘efficiency/synergy’ merger appear overwhelming. A merger between two large US Legacy carrier could benefit both airlines to have a strong route network and take overcapacity out of the market. However, combining two large US Legacy carriers would not pose an insurmountable threat to future competition in itself, but granting antitrust immunity that would allow active international price and scheduling collusion between a much larger set of former competitors (CO-UA-US-LH-SK-AC-LX-OS-TPLO- BD in this hypothetical case) is a much more serious issue, and if permitted would likely lead to further combinations and extreme concentration.

### **Consolidation and mergers in Europe**

There is no real evidence of consolidation to date in Western Europe. We see just occasional pauses for short-term corrections before expansion resumes. The industry has been just as dynamic as the US, as 160 out of 312 airlines have been “consolidated”. The large number of carriers and the steadier growth relative to the US reflect weaker scale/scope economies, given fragmented markets and more routes served by point-to-point (Charter/LCC) carriers. The number of intercontinental carriers has remained virtually unchanged over the last 25 years.

The ‘Single European Flag Carrier’, introduced 20 years, is evolving into three models:

- Very large intercontinental hub carriers
- LCC’s and former charter carriers: serving high demand and price sensitive markets from lower cost airports
- City network carriers: operating more business-oriented short haul routes from main airports with lower labor costs and simpler operations than the Intercontinental carriers)

Demand for low-fare travel is still vibrant and competition remains highly dynamic, with carriers frequently entering and exiting the market and it is expected that mergers will only play a limited role. Mergers can make sense when slots or similar assets are scarce, or as a way to efficiently expedite the shakeout in a specific national market. The most successful are the ones who have most dramatically restructured costs and product complexity and are close to natural limits of ultra-low strategy (Aer Lingus and Ryanair).

In 2000, Europe counted 13 hubs with a significant number of intercontinental flights dependent on EU connecting traffic. Only 35-50% is OD traffic or terminating at the hub city, all these hubs were directly competing for the same base of connecting traffic.

This suggests that the number of intercontinental hubs that can successfully compete is limited, also because of the high cost marketing infrastructure needed to support global sales. On the other hand, there is huge long-term demand growth and clear potential for ongoing innovation and productivity gains. Consolidation associated with mature, slow-growth industries cannot be justified here and also governments will always be subject to pressure from incumbent carriers, because they intervene to increase competition.

The most obvious merger in Europe has been between Air France and KLM. This merger can be best described as an “efficiency-synergy” merger and an attempt to engineer a two-airline duopoly of the huge continental Europe-intercontinental market in the longer term, while neutralizing the threat of serious competition in the short-term. By acquiring KLM, Air France not only eliminates a viable competing network, but it eliminates one of the market's most aggressive price competitors. Because of this, the increased profitability of the AF-KL group appeared largely driven by the strong revenue conditions in many long haul markets, but these yield improvements either come from neutralising KLM price competition or would have occurred without the merger. Since there have been no staff cuts, capacity reductions or operational integration, the cost savings (€100 m per year) that have been claimed are likely to include many savings that the two companies could have achieved independently.

The EC permission for AF-KL can be interpreted as a politically acceptable way to expedite the exit of hopelessly unprofitable long haul competitors such as Alitalia. The biggest problem are the barriers to exit, that protect these hopeless carriers from needed restructuring and block opportunities for more efficient, better run airlines. On the other hand, it leads down a further slippery-slope of further collusion and mergers, each justified by government approval of the previous move. Question is if the EC continues actively interfering in Europe-intercontinental market competition in order to establish the desired “pan-European leaders”. Any government attempts to engineer the strongest position for EU flag carriers will likely have the opposite results. There is a campaign going on between a set of carriers where they are harboring a vision of a world where dozens of these huge intercontinental carriers will be merged into perhaps three airlines (AF-Lufthansa for example). In this way, it will reduce competition and drive up prices. IATA is the only organization with the global reach and can play a decisive role in the future of the industry.

### **Consolidation and mergers in Asia**

In China, policy focused on a “Three Airline” policy, led by Air China, China Southern and China Eastern. The short-term objective was to facilitate a major restructuring of smaller carriers and on the longer-term to expand the Chinese flag share of international traffic by creating multiple carriers that could compete with foreign carriers from well established Asian hubs.

However, there is a fundamental disconnect between extreme concentration and the basic economics of domestic Chinese aviation. Domestic hubs make no sense; Chinese geography has none of the characteristics for effective hubbing: a rich mix of small markets. Southwest-style point-to-point networks seem ideally suited to provide the service and low fares the Chinese market wants. But any attempt to succeed internationally by setting up strong international hub-networks could totally undermine the cost discipline and operational simplicity needed to succeed domestically.

Chinese's desire to develop more internationally competitive carriers is fully understandable, but a government policy emphasizing domestic mergers and industry

consolidation was the wrong way to go about it. This policy has undermined the cost discipline and operational standardization the domestic market required, without creating meaningful domestic long haul feeder networks at any Chinese hub. Meanwhile, Cathay Pacific took over Hong Kong Dragonair by CNAC (Air China's principal shareholder) improved the position of Cathay by connecting interior Chinese cities to long haul destinations. Also five new carriers have recently started services following LCC approaches.

**Source:**

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