Star Alliance, 2000

Bringing together airline organizations that span the globe is very complex but we are ready to accelerate the process. We are clearly ahead of the competition, and we intend to maintain that lead.

-- Friedel Roedig, Chairman of Star Alliance

During the 1990s, the global airline industry was being transformed by new regulatory policies and new company strategies. The United States deregulated the industry in 1978 and the European Union followed in 1997. While regulatory hurdles still prevented cross-border mergers in many countries, airlines were driven to pursue different strategies, from privatization to the formation of global alliances.[1]

Star Alliance was created in May 1997 by Lufthansa, United Airlines, Air Canada, Thai Airways, and Scandinavian Airways System (SAS); Varig, Air New Zealand, Ansett, and All Nippon Airways (ANA) joined in 1998. The founding members sought to expand their global network of service and attain many of the synergies of a merger, but while maintaining their independent identities.

Despite great strides that Star was able to make over a short interval, several critical issues remained in 2000 and were likely to increase in importance. Success of the alliance was likely to depend on its organization and management, but few companies had experience with the type of structure that Star was building. Would it work? Would the airlines continue to operate as independent companies or function as almost-merged entities? If they remained independent, how would power and benefits be divided among them? With rival alliances growing in strength, how would Star compete? Would it continue to expand its network of allies, or would its growth reach a point of diminishing effectiveness?

Research Assistant Sarah Marchand (MA '99) prepared this case under the supervision of Associate Professor Benjamin Gomes-Casseres as the basis for class discussion, rather than to illustrate either effective or ineffective handling of an administrative situation. The case draws on research done by Exchange Students Guillaume Hery, Igor Pruniaux, and Thomas Ostergaard, and is based solely on library sources.

[1] The airline industry continued to be affected in one way or another by highly complex foreign ownership regulations. These regulations effectively prevent full mergers between airlines domiciled in different countries. For example, non-Canadian investors could not own more than 31% of a Canadian airline's voting stock.

The Rise of Airline Constellations Star was a new form of organization in the industry in that it was a "constellation" of multiple partners. Historically, airline alliances had been bilateral, that is, between two companies. For example, Air France had twenty-four bilateral alliances in 1998, with different airlines across the globe, but it had not linked these separate alliances into one global alliance. That is what Star did – it was a multi-partner alliance formed to exploit synergies and reduce costs among multiple partners at once.

Even so, Star relied foremost on its two biggest member companies, United Airlines and Lufthansa, which together serviced 578 destinations in 106 countries. By the end of 1999, Star was composed of twelve members with 800 destinations in 130 countries, with still other companies planning to join in the near future (see **Exhibit 1**). Star tried to strengthen its position in South America, Central Europe, the Middle East, and Asia. It was also developing new methods to improve the service of its members, such as through a new E-Ticket Service, by adding technologically advanced Boeing 777s, installing Airport Gate Readers, and so on.

Star was not alone in forming a multi-partner alliance. While Delta Airlines, Singapore Airlines, and Swissair had formed a three-way alliance in 1989, rivalry among large constellations did not take off until American Airlines and British Airways launched their Oneworld alliance in February 1999. Among the founding members of this rival constellation were also Canadian Airlines, Cathay Pacific and Qantas. In September 1999, Finnair and Iberia joined, resulting in 650 number of destinations served.

A comparison of key performance statistics of the main airline constellations active in 1999 is shown in **Exhibit 2**.

Regulated Competition in the Global Airline Industry

Air travel was a huge industry operating on a global scale. In 1999, the 269 member airlines in the International Air Transport Association (IATA), together transported over 868 million passengers (of which 27% were flown internationally) and had operating revenues of $150 billion, growing at 5% per year.[2] Company performance in the airline industry was cyclical, a product of changing consumer demand and the price of inputs (particularly fuel). Performance of selected airlines is shown in **Exhibit 3**.

The profitability of an airline depended on three primary variables: costs, pricing and occupancy rates, or load factor.[3] The typical cost structure within airline companies was such that ticketing and promotion represented the largest share of costs, with fuel expenses following close behind. Major airlines were dedicated to reducing marketing costs in part by cutting commissions, introducing on-line booking, and establishing their own online reservation systems. Star Alliance opened two such agencies that were operated by the constellation of members. With the spread of the Internet, airlines were devoting larger amounts to advertising on-line in an attempt to increase their load factor.

Because a vacant seat cost the airline virtually as much as an occupied seat, profitability depended highly on the load factor. Soaring fuel prices during the Gulf War in

[2] www.iata.org

[3] Load factor is a measure of capacity utilization, equal to total revenue per mile (RPM) divided by total available seat miles (ASM).

the early 1990s led many companies to suffer considerable losses; the overall industry lost $16 billion from 1990 to 1993. In turn, the low fuel prices that followed, along with the buoyant global economy, raised profits to $18 billion from 1994 to 1998.[4] Glenn Engel of the Transport Group at Goldman, Sachs & Co. reported:

> In terms of profitability, the years from 1991 to 1993 were, historically, the industry's worst ever. But the next five years were its best ever, especially 1998, when earnings peaked. In 1999, earnings came down a bit -- probably 20% from 1998, but they were still strong. So I guess you could say the 1990s were the best of times and the worst of times!

Regulation and De-regulation Traditionally, the industry had been regulated by national governments in a multitude of ways. For the most part, routes had to be approved and licensed by government agencies; prices were set by negotiation between governments and by national authorities; foreign ownership was restricted in national airlines; and airlines were restricted to flying only to and from their home countries. International rules of "*cabotage*" restricted airlines from operating domestic flights in countries other than their home bases. In other words, a German airliner was allowed to fly from Germany to the United States and back, but not between two cities in the United States.

The birth of airline alliances came as a result of deregulation. Starting in the U.S. in 1978 and spreading to the European Union (EU) in 1993, a wave deregulation loosened restrictions on pricing and on routes. Europe-Union airlines were also permitted the right to fly to and from all international destinations within the EU area. In April 1997, law makers in EU cou tries gave the right to carriers from one country to travel domestically within other EU countries, modifying the long-standing rules of *cabotage*. However, travel to and from non-EU countries was still subject to bilateral negotiations and the traditional *cabotage* rules.

Beginning in 1992, the governments of the U.S. and the Netherlands signed a new Open Skies bilateral air treaty that allowed U.S. airlines to fly without restrictions to Dutch cities, and the reverse. The treaty also granted KLM and Northwest full antitrust immunity to pursue an alliance, though they were not allowed to merge ownership. After that, the U.S. made similar agreements with 36 other countries. These policies successfully eliminated restrictive bilateral alliances and liberalized air routes across the globe. Among the benefits that countries received in signing an agreement with the U.S. was permission for U.S. national airlines to cooperate with the foreign airline in designing, pricing, and selling their product.[5]

Despite their aggressive approach, the U.S. carriers were not free from international regulations. An Open Skies agreement still does not grant the U.S. the right to *cabotage* in the foreign country's domestic market. But by joining in an alliance, a U.S. carrier could connect more effectively to the domestic route structure operated by the foreign airline.

Anti-trust Issues The traditional form of alliance in the industry had been one of loose ties between two partners, with no equity cross-participation; there were a few exceptions, such as British Airways, which was likely to take an equity interest in its partners. One of the features of these alliances is that they enabled the partners to overcome some of the restrictions imposed by national regulations.

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[4] www.iata.org

[5] Global Airline Alliances, Candace Browning & Michael Linenberg. Merrill Lynch, 1999.

Though many industries had seen the decline or elimination of “national champions” in the 1980s and 1990s, this did not happen to the same extent in airlines. In a lot of countries, national airline companies were either state-owned or protected by the government. In Europe, even after the creation of the single European market in 1992, the rule was generally that no foreign investor was allowed to own more than 49.9% of the capital of a national airline. In the United States, the threshold was even lower at 25% foreign participation. Airlines were still widely regarded as national assets.

Although United, Lufthansa and SAS had received anti-trust immunity from the U.S. government, United’s Jerry Greenwald was careful in stating that “the partnership only entails collaboration on industry standards. It is nothing more than the transformation of what has already been agreed, under previously approved agreements, into a multilateral format.”[6] Star was confident that they would not encounter any regulatory hurdles precisely thanks to their loose form of agreement. And indeed, all the necessary U.S. approvals were obtained.

But there was a concern about the future. Legislation in Europe and the U.S. was clearly not prepared for the emergence of global alliances such as Star or Oneworld, and state regulators had only started to catch up with the new, emerging structure of the airline industry. Karl van Miert, responsible for overseeing competition rules at the European Commission, said in July 1999 that alliances were equivalent to mergers, and therefore should be treated as such.[7] The main features of a merger are present within alliances, he reasoned, such as coordinated flights and joint purchases.

On major routes, therefore, alliances could conceivably be anti-competitive, and subject to being blocked by anti-trust authorities. For example, Delta-Swissair had a near-monopoly on Zurich-New York route, and AA-BA had a near-monopoly on the London-Dallas route. Furthermore, AA and BA ran into a lot of trouble to formalize their union, and failed to get anti-trust immunity, because of the threat of monopolization of North Atlantic routes. As such, they could not coordinate the prices of their tickets and even had to keep separate their mileage programs in North Atlantic routes. Sometimes, the monopoly issue can only be resolved by imposing “carve-outs,” or banning alliance activity on routes where the partners have a monopoly. For the case of AA-BA, the authorities ruled that the partners would have to give up 267 of their slots at congested Heathrow Airport to get anti-trust immunity, a condition which they were not ready to accept.

On routes requiring a connection, alliances appeared more likely to be pro-competitive. They might be able to offer more frequent flights and shorter connections for secondary destinations at a reasonable price. A 1997 University of Illinois study, funded in part by United Airlines, concluded that average fares on international routes on non-aligned airlines were 36% higher than fares on airlines that were allied. Star’s officials used this study to argue that their alliance was beneficial to customers.[8]

Regulatory issues could also influence the battle between competing airline constellations. Star took advantage of the fact that BA and AA were not authorized to cooperate fully over the North Atlantic. This tactic was denounced by BA and AA officials,

[6] Aviation Week and Space Technology, 97/05/19
[7] La Tribune, 99/09/03.
[8] www.star-alliance.com

who found 14 monopoly nonstop transatlantic routes operated by the SAS-United-Lufthansa trio. At the birth of Star, they urged regulators to disapprove that alliance. As a response, Lufthansa officials said that Star would not pose a threat from the standpoint of market dominance, as the AA-BA alliance appeared to do over the North Atlantic. Lufthansa's share of traffic between Germany and North America is only 30%, compared to the 70% share that AA-BA would have in traffic between North America and the United Kingdom. British Airways brought the issue to the table again when British Midland announced they would join Star. Bob Ayling, BA's CEO, said he did not understand why Lufthansa and United would be granted anti-trust immunity if they could now also have access to the U.K.-U.S. routes via British Midland. He threatened to bring the subject to the European court in Brussels.[9] As of the end of 2000, this legal skirmish was still unsettled.

Benefits of Star Alliance

Network Optimization Star promised to allow its member airlines to take advantage of an extended "hub and spoke" system. The hub and spoke system first became popular in domestic air travel in the United States after deregulation of the route structure. In this system, the main airports in the country served as hubs through which passengers were channeled from and to various spokes that connected the hub to the ultimate destinations.

Through Star, for example, United's passengers had access to Munich, Hamburg, Frankfurt and other German cities connected to the Dusseldorf hub. Similarly, Lufthansa did not fly from Frankfurt to Denver, New Orleans, Honolulu, and Seattle, but United did; so Lufthansa could bring its passengers to Chicago and United could then take them to the ultimate destinations. An airline "with 5 airplanes serving 55 cities from one hub, can serve 141 cities with the very same fleet by linking their first hub to another in a global alliance" said United's Michael Whitake.[10] So, Lufthansa and United, in this example, had access to millions of new customers, which tended to increase both airlines' load factors.[11]

The spread of the hub-and-spoke system had resulted in most major airports being dominated by a larger carrier. Because of the limited availability of landing slots, gates, and takeoff times, it became difficult for other carriers to service a new location. Prior to winning the bid for British Midland, Star members could not service the London Heathrow hub, which was dominated by British Airways. When British Midland joined Star, this posed a potential threat to BA, which had long dominated the transatlantic routes.

[9] The latest round of bilateral negotiations between the U.K. and U.S. ended in late January, 2000, without any agreement. This reduces the likelihood that British Midlands will be allowed to serve the U.S in the near future, while a third U.S. carrier be permitted to serve London Heathrow. Currently American Airways and United Airlines are the two U.S. carriers permitted to serve Heathrow.

[10] La Tribune, 99/09/03.

[11] Code sharing allows two independently operated airlines to share the same code on connecting flights. A passenger booked on a Los Angeles to Frankfurt flight with a connection in Denver would have a single flight number and seamlessly transfer to the planes or route systems of all the allying partners. These flights are usually given priority on booking agents CRS screens, making it less likely for passengers to book with other connecting flights with different codes. This also increases the opportunities to cross-sell, benefiting the partners.

These and other benefits of Star resulted in higher revenues for members. In 1999, Lufthansa estimated the benefits it gained from the alliance at $230 million, or one third of the airline's operating profits.[12] For United, additional revenues from cooperation with its partners were estimated at $170 million in 1997, $250 million in 1998, and $260 in 1999.[13]

Buyer Power Another objective of many airline alliances was to combine purchases and increase the buyer power of the partners. United's CEO Greenwald stated: "About one-third of United's costs involve people. But the other two-thirds represent enormous opportunities for working together, for buying, purchasing and co-operating among the group."[14] There were also potential economies of scale available through joint purchasing in other areas. Star carriers' combined purchase of goods and services--aircraft not included--amounted to approximately $15 billion annually; this included general expenses like office equipment (Lufthansa and SAS had already jointly purchased computers), fuel, catering, and maintenance.

In 1998, United said that it saved $20 million thanks to common purchases, out of a total of $1.5 billion of purchased services. At the press conference announcing the creation of Star Alliance, Lufthansa CEO Juergen Weber noted that his company had managed to save $120 million from its partnership ventures in 1996, with $60 million in savings coming from Lufthansa's collaboration with SAS alone. He made it clear that he expected similar results from his cooperation with the others in Star Alliance.

Regulatory Influence Alliances also tended to strengthen the influence of member carriers in regulatory negotiations. One of the reasons why British Midland chose to join Star was that it expected that being a member of such a large constellation would allow it to obtain some concessions from U.S. and U.K. regulators. Flights between the U.K. and the U.S. were restricted and only British Airways and Virgin Atlantic could operate on these routes. "Joining Star Alliance should make us gain more influence and release those constraints," said Midland's CEO.[15] He expected that Star's leaders, Lufthansa and United, could force regulators to eliminate these constraints. The benefit to Lufthansa and United, of course, was to use British Midland's slots at Heathrow for transatlantic flights.

Passenger Benefits The formation of Star Alliance provided customers with an integrated worldwide airline network with global recognition. Focusing on customer relations, this alliance aimed to enhance global travel, making it more convenient and simple for its customers, while meeting their needs in ways that individual airlines could not.

The member airlines were most often located in the same terminal, with neighboring gates allowing for convenient transfers and passenger connections. By coordinating their schedules, connection times between member airlines could be reduced to a minimum. When delays occurred, the connections were protected, monitored, and re-accommodated on a pro-active basis. Most passengers were offered "through check-in" so that they were checked right through to their destination. The simplicity and consistency of quality in member services permitted customers to feel as though they were traveling with the same airline throughout their trip.

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[12] www.lufthansa.com
[13] www.ual.com
[14] Airline Business, June 1999.
[15] Les Echos, 99/10/16

Following extensive research, Star Alliance made a number of changes to meet the expectations and needs of its frequent international fliers. Customers could earn mileage points whenever they traveled on any of Star Alliance's airlines. The points would accumulate and could be credited toward different Star Alliance programs, such as the Gold or Silver status programs. This allowed customers to reach elite status within the frequent flier programs faster, as every point counted toward that status. By 2000, corporate clients were key to profitability at all major airlines, but especially at those airlines servicing cross-continental routes.

In the Gold and Silver programs, top-tier and middle-tier members had access to the highest level of service at airports around the world and were given priority treatment from check-in to baggage claim. Star offered its elite customers a seamless travel experience along with tangible benefits. Upon presentation of their ticket, customers were directed to the Star Alliance lounge, which provided fine cuisine, beverages, access to global news, Internet access, and other business amenities.

An additional benefit to Star Alliance travelers was a new global Internet tool.[16] This service permitted customers to choose their Star Alliance flight and make their own reservations via the Star website. The site was user-friendly, simple, and convenient, and allowed customers to plan their travels 24 hours a day, 365 days a year. This site was integrated with a "booking engine" and linked to a major computer reservation system (CRS). The CRS confirmed the customer's reservation and ticket cost in the local currency. Customers could then have their tickets sent by mail, picked up at a specific travel office or airport, or they could opt for an electronic ticket.

Managing Star Alliance

Executive Leadership It had not been a simple matter for Star to combine the management of such a large number of airlines, two of which, United and Lufthansa, were among the largest and most powerful airlines in the world. (Performance of the main member airlines of Star is shown in **Exhibit 4**.) Gerard Greenwald, chairman of United Airlines, was proud that there were "not more than four pages in the Star Alliance contract."[17] And indeed, no formal structure was created to manage the alliance at the time of its creation in May 1997. This situation changed in December 1998, when a new focused management team was charged with implementing a five-year business plan approved by the airlines' chairmen during a previous meeting in Rio de Janeiro (see **Exhibit 5**). From this date forward, day-to-day operations would be directed by a core group of executives, who were picked by the airlines. The new Alliance Management Board dealt with specific areas of strategic importance to Star, in addition to allocating a specific budget for the realization of the alliance.

Quality Control Providing a consistent quality to customers, regardless of what company they traveled with, was a key success factor for Star Alliance. The first five Star members therefore set rigorous standards that would have to be met by any new Star member. While Star had no intention of instituting a completely homogenous product across its members, it did have a set of standards with regard to the quality of seating, basic amenities,

[16] This system was implemented on October 15th, 1999.
[17] Airline Business, June 1999

and services which had to be met before a carrier became a full member. For example, All Nippon Airways had to put in place new systems to provide Star premium passengers with facilities like priority waitlists and lounge access. "It takes almost a year for a typical airline to come up to the Star standards," said Rupert Duchesne, vice-president for marketing at Air Canada.[18]

A new member also needed to have previous partnerships with each of the other member carriers individually. This was to ensure that code-sharing could be implemented right away. (Code sharing was a system whereby two partner airlines could list the same physical flight as their own, in effect having the flight carry two reservation codes.) Varig did not meet that condition when Star was created, which is why the Brazilian company had to wait until October 1997 to join. Although there was no clear requirement against other partnerships existing outside the Alliance, the evolution of Star showed that when a company joined Star, its previous partnerships were often abandoned or integrated into Star. Varig again recognized that Star had a "certain weight" and so abandoned its code-share agreement with Delta.

Brand Management In founding Star Alliance, the members sought to create a brand name that would become known internationally, yet would not act as a substitute for their existing brands. Persuaded by in-depth customer research, the members judged that customers had no interest in losing the individual airlines' differentiation by brands, identities, customs, and service style. Passengers wanted access to a single global network that was as seamless as possible, along with the established status and recognition of the member airlines. Star managers concluded that the best way to achieve this was with an umbrella brand. Hence, the planes kept their original logos, which was complemented by Star's logo on the forward fuselage, as well as on ticket jackets, promotional items, and signs.

Still, a debate continued over whether Star members should increase their level of integration and develop common values, service styles, and products. Here again, customer surveys were used, and it turned out that the absence of core values within the alliance was not an issue. Passengers did not complain too much about the differences when traveling with another airline, perhaps because the Alliance did strive to reach some level of commonality during the selection and training processes.

In 1999, only three of the global airline constellations had created umbrella brands: Star, Oneworld, and Wings. In the case of Star, while its brand name continued to act only as an umbrella, its position and recognition had grown stronger over the years. Its power stemmed from the network as well as from the overall level of service in the alliance. Still, the individual performance of member airlines mattered. If a customer had a poor experience on a flight, both the reputation of that airline and the reputation of the alliance would be harmed.

Costs of Building the Alliance The main costs building Star Alliance revolved around the training of personnel and the implementation of information technology (IT) systems. Star faced a major challenge in enabling its members' reservation and inventory systems to talk to one another. More than half of the Star Alliance budget in 1999 was directed towards developing IT solutions. Another challenge lay in training staff to deliver consistent service

[18] Airline Business, Jan 1999.

and customer support across the alliance. Star officials said they would allocate more resources and spend more time on training in 1999 than in any previous year.

By comparison, Oneworld also went through an intensive training program during the last part of 1998. Its main goal was to train staff to deal with customers from other airlines. At the heart of the program was a set of core messages agreed to by the partners, including "recognizing people as individuals and respect for individuals, while celebrating the different cultures and atmospheres between the airlines."[19]

Implementation Problems Members of the Star Alliance knew that it would take time for them to implement all the actions they had announced in May 1997. On the second anniversary of Star's creation, the chairmen of Lufthansa and United held a press conference in Sydney to describe how things were going after two years. "The alliance journey has only begun," said Greenwald of United. "We do recognize that there is no history for what we are doing. We are going into places where no others have gone. We don't have a blueprint for what we will become."[20]

Indeed, there was still a lot of skepticism among passengers regarding the benefits of the alliance. Star conducted a survey that showed that customers thought the alliance was especially good for the airlines, but not necessarily beneficial for passengers. Economy-class passengers were critical of the many restrictions on redeeming frequent flyer miles on partner airlines. Frustrating conditions continued to surround passenger privileges such as access to airport lounges. Bruce Harris, United's director of alliances and deputy chairman of Star's Management Board recognized that first-class and business-class passengers had been the main focus during the first two years. So far, they had done the easier things, he noted, such as enabling passengers to earn and burn miles on the existing partners' services, providing lounge access, and enabling priority check-in and wait-listing for frequent flyers with elite status.

Consistency of service remained a difficult issue that would likely take much more time to address. The experience of the KLM/Northwest alliance suggested that it was questionable whether any amount of training could lead to a completely consistent product. "No airline is able to deliver consistency throughout its own product throughout the year, and it is even more difficult with an alliance," said KLM's Zeegers.

Seamless service, which meant a smooth connection and a similar travel experience among partners, could only be developed gradually. At Star, the partners were sharing terminals wherever possible and there was Star Alliance signage at the largest 35 airports worldwide. Key ticket offices were being merged. But it was not always easy to get the needed approval from airports. For example, Star had been insisting for more than one year that the Paris airport at Roissy change terminal allocations so that Lufthansa, United, SAS and Air Canada could share the same terminal (Roissy 2A). But by 2000 this demand had not been satisfied, despite intensive lobbying from Star members. The four Star companies represented 10% of the flights at Roissy, and generated more than $800 million in revenues with 1000 employees in Paris. Friedel Roedig, chairman of Star's Management Board criticized Paris officials for transferring American Airlines to a terminal shared with British Airways.

[19] Airline Business, Jan 1999.
[20] Airline Business, June 1999.

Miami International Airport had been more cooperative. Its capital improvement program accommodated the alignment of airlines under the Oneworld, Star, and the Northwest-Continental alliances. A previous master plan had located American and United next to each other; the new plan separated the carriers and allocated space for their partners.

The Future of Airline Constellations

Despite the complex web of regulations, the global airline industry appeared to be moving towards long-term consolidation. Airlines were finding new ways to maneuver around the rules and capture potential synergies of cooperation. In November 1999, Alitalia and KLM began a 50-50 joint venture that permitted them to operate both passenger and cargo services under one management, acting in essence as a merged company; shortly after its launch, however, this alliance collapsed when the partners failed to reach agreement on key issues.

Even though large cross-border mergers had not yet been legalized, $6.8 billion worth of merger transactions occurred in the industry in 1999.[21] Many companies purchased smaller regional carriers; for example, Delta Air Lines acquired Comair Holdings and ASA Holdings. Others took bolder steps, as when Singapore Airlines took a 49% position in Virgin Atlantic Airways Ltd. The airlines were not waiting for the regulations to change. Experts predicted that consolidation was the next natural economic step in the evolution of the airline industry. As ownership regulations were relaxed, they reasoned, economic forces would exert themselves and the number of airlines would shrink, while remaining ones would increase in size.[22]

But even as the trend toward consolidation loomed large, concerns over the individual interests of airlines also became more apparent. As additional airlines joined the existing constellations, the route structures of members in each alliance became increasingly overlapping. For example, when Singapore Airlines entered Star Alliance, Thai Airways financial consultants wondered what the status would be of Thai's existing role in Star as the airline that connected European hubs with Southeast Asia. The entrance of Singapore Airlines, could cost Thai $10 million annually in lost Lufthansa code-share revenues. In addition, Singapore Airlines was Thai's most powerful regional rival in Southeast Asia. Although Thai's president confirmed that the airline had no intention of departing from the alliance, similar issues or problems were likely to appear elsewhere in the alliance and in rival alliances. If the airlines were to merge, the new entity would then be able to eliminate weaker routes in favor of stronger, more profitable routes.

The Battle Front in Canada Amidst this global trend toward consolidation, Canada became a key battleground among the global airline constellations in 1999. With plans to buy and merge Canada's two largest airlines, Air Canada and Canadian Airlines, the Canadian holding company Onex had made a $1.8 billion bid for Air Canada, acquiring 31% of its shares. In response, Air Canada made a counter-offer to buy back its shares from Onex and purchase Canadian Airlines. This takeover battle was, in effect, a battle between global airline constellations. Star Alliance sided with its member, Air Canada, and Oneworld sided with its

[21] Thomson Financial Securities Data.
[22] "Virtual Mergers: With Traditional Mergers Difficult to Pull Off, Airlines are Finding Creative Ways to Consolidate" Investment Dealers' Digest, 2000

member Canadian Airlines. Onex's original bid was backed by American Airlines's parent company, meaning that after a merger, Air Canada would leave Star and join Oneworld. Air Canada's counter-offer was financed in large part by United and Lufthansa.

This takeover battle prompted regulators to put pressure on the federal government to review Canada's national airline policy, which for decades had supported two national carriers. In addition, regulators of the European Union began an in-depth investigation based on fears that this merger would harm competition on transatlantic routes.

Just hours after the superior court ruling in Montreal, Onex withdrew its offer. As it happened, the judge ruled that the Onex/AMR plan would violate Canadian law, which prohibited foreign ownership of more than 10 percent of Air Canada. Unlike Onex's proposal, Air Canada's plan would not violate existing regulation. Robert Milton, President of Air Canada characterized the deal as follows:

> [A] realistic, practical and dynamic solution for a sustainable, profitable, competitive and Canadian-controlled airline industry. It is fully compliant with the existing laws of Canada governing Air Canada. By any measure, this is the best solution for Canada.

After Air Canada's bid for Canadian was approved, it became the dominant air carrier in the country. Air Canada planned to continue to operate Canadian as a separate entity for the short term, until Canadian had restructured its debt. Canadian would also leave Oneworld and officially join Star in the fall of 2000.

Management Choices Ahead With the new millennium came a new array of questions for the management of the global airline constellations. After achieving benefits and synergies from an alliance, what were the next steps? Should larger airlines acquire smaller companies? Or should individual airlines continue to operate as separate entities under an alliance umbrella? What would be the potential costs and benefits of each alternative? With the expectation of further deregulation, analysts and management pondered these questions, not yet certain of the direction the carriers would take or the impact each decision would have on the airline industry. Although the vision of the future structure of the airline industry was left uncertain, analysts contended that the Star Alliance would remain a dominant force.

Exhibit 1 Time Line of Airline Industry

- 1978 US Congress announces deregulation of airline industry.
- 1983-1993 American airline flights increased less than the inflation rate. They focused on low fare strategies.
- 1993 Price restrictions on all flights within the European Union were eliminated.
- 1993 European airlines were allowed the right to propose all international destinations within Europe.
- U.S.-China bilateral agreement. United and Northwest gain access to Chinese market and begin operating routes.
- 1997 European laws allowed carriers from one European country the right to cabotage (domestic travel) within another European country.
- May 1997 Star Alliance was created joining United Airways, Lufthansa, Air Canada SAS and Thai Airways.
- October 1997 Brazilian Varig joined Star.
- May 1998 Ansett and Air New Zealand joined Star.
- September 1998 Oneworld announced plans to create a competing alliance in early 1999 joining American Airlines, British Airways, Qantas, Canadian Airlines and Cathay Pacific.
- ONEX made a hostile takeover bid for Air Canada and Canadian Airlines.
- October 1999 All Nippon Airways joined Star.
- October 1999 Air Canada counters ONEX's takeover bid with a plan to buy back its shares and take over Canadian Airlines, financed in part by United and Lufthansa.
- March 2000 Austrian Airlines along with its partners Tyrolean Airways and Lauda Air joined Star.
- April 2000 Singapore joins Star.
- July 2000 Mexicana joins Star.
- Fall 2000 British Midlands expected to officially join Star.

Source: Compiled by case writers from press reports.

Exhibit 2 Comparison of Global Airline Constellations, 1999

(Based on aggregation of statistics of member airlines)

		Star	Oneworld	Wings	Delta
Geographic Networks	Number of Destinations	974	745	515	654
	Number of Unduplicated Routes*	4,242,581	3,864,339	2,047,433	2,279,085
	Number of Departures	2,261,236	1,853,308	1,467,141	1,649,862
	Available Seat Kilometers (ASK) (000)	667,737,094	734,846,065	386,600,890	380,899,126
	Kilometers Flown (000s)	3,221,189	3,415,500	2,148,253	2,099,721
Market Size	Major Market Presence	21.70%	24.20%	16.20%	11%
	Passenger Revenue (US$M)	47,570	46,892	24,869	25,307
	Number of Passengers	241,814,525	206,469,766	134,836,113	156,801,941
	Revenue per Kilometer (RPK) (000s)	466,599,414	518,855,826	284,379,917	274,634,264
Network Density	Passenger Rev. per Unduplicated KM*	11,212	12,134	12,147	11,104
	RPKs per Unduplicated KM	109,980	134,268	138,896	120,502
	ASKs per Unduplicated KM	157,389	190,161	188,822	167,128
	No.Departures per Destination	2,322	2,488	2,849	2,523
	Passenger Rev per ASK (cents)	7.12	6.38	6.43	6.64
Financial Strength	Pre-Tax Margin	4.80%	4.80%	7.40%	6.40%
	Debt as a % of capital	68.70%	70.10%	84.30%	74.90%
Regulatory Freedom	Antitrust Immunity	Yes	No	Yes	Yes

(*) "Unduplicated routes" counts the distance between two points in the route structure once, regardless of how many flights the airline has between those two points. It is a measurer of the network size of each airline; it does not take account of duplication that may exist within the constellation, such as when two members fly the same route. In the latter case, the route distance is counted twice in this table, as it would appear as "unduplicated route" in each member's network.

Source: Merrill Lynch

Exhibit 3 Performance of Selected Airlines

Airline	5/31/99 Share Price (US$)	52 Week High	Low	Equity Mkt Capitalization (000$)	Dividend Yield	P/E Ratios 1997	1998	1999E	2000E
Lufthansa	20.3	28.8	13.7	7719	3%	17	14.5	14.5	NM
United	67.25	94	55.25	8374	0%	3.8	6.4	7	7.4
SAS	9.40	16.72	4.35	1547	4.3%		11.4	10.9	NM
Air Canada	3.38	11.19	3.19	1885	0%	5.38	61.5	13.01	5.26
New Zealand	0.91					5.2x			
Thai	1.70	2.16	0.76	2378	0%	17.6	23.9	12.1	11.9
Nippon	3.06	4.27	2.75	4418	0%	NM	NM	NM	NM
Singapore	8.69	9.62	3.71	11146	1.8%	11	17.4	15.6	NM
Delta	57.38	72		8192	0.2%	8.3	8.4	8.3	7.7
Northwest	33.25	45	18.625	2702	0%	NM	NM	8.8	7.6
American	65.06	89.94	45.63	11863	0%	11.9	8.8	13	9.9
British Airways	72.5	114.75	52.125	7780	4.2%	12.7x	30.1	17.8	14.3
Quantas	2.94	2.99	1.42	3456	5.6%	10.6	17	14.6	13.5
Continental	39.25	65.125	28.875	2339	0%	7.7	6.5	7	6.5
KLM	29	49.69	23	1798	2.6%	7.5	12.1	8.9	NM
Cathay Pacific	1.37	2.85	0.63	7891	1.9%	14.3	NM	34.4	14.4

Source: Casewriter

Exhibit 4 Operations of Members of the Star Alliance

Airlines	Number of Destinations	Number of Unduplicated Routes KMs	Number of Aircraft Departures	Kilometers Flown(000)	US $ Passenger Revenue	Number of Passengers	Pass. Rev per Undup Route KM	No. of Departures per Destinat	Pass.Rev per ASK (cents)	Pre-Tax Margin	Debt as a % of Capital
Lufthansa	155	906,904	477,665	559,949	9,569	35,293,436	10,551	3,082	9.72	7.1%	62.9%
United Airlines	136	801,433	798,131	1,396,789	15,342	34,291,741	19,143	5,869	5.64	6.6%	85.4%
Varig	122	489,225	143,424	207,406	3,252	10,488,334	6,650	1,176	9.14	0.7%	92.2%
Thai	74	611,456	95,272	153,432	2,157	14,379,496	3,528	1,287	4.69	4.7%	98.7%
Ansett Australia	80	164,584	na	na	2,539	13,469,000	15,429	na	10.16	0.1%	81.9%
Air New Zealand	33	239,477	na	85,678	1,540	7,026,000	6,431	na	5.29	5.9%	53.9%
Air Canada	65	353,161	210,119	323,947	3,273	15,636,838	9,269	3,233	6.35	4.8%	82.7%
SAS	102	222,307	327,308	245,016	3,568	20,621,142	16,052	3,209	11.39	5.7%	61.1%
All Nippon Airlines	207	454,034	209,317	248,972	6,326	40,697,231	13,934	1,011	8.03	-0.2%	47.6%
TOTAL	974	4,242,581	2,261,236	3,221,189	47,570	241,814,525	11,212	2,322	7.12	4.8%	68.7%

Source: Merrill Lynch

Exhibit 5 Management Structure of Star Alliance

Executives	Position at Airline	Position at Alliance
Friedel Roedig	Executive Vice President, Alliance for the **Lufthansa** Group.	Chair of Star Alliance Management Board
Bruce Harris	Director, Alliances for **United Airlines**	Deputy chairman
Ross MacCormack	Vice President Corporate Strategy for **Air Canada**	Responsible Global Network, including regulatory issues
Per Stendebakken	Area Manager Europe West for **SAS**	Responsible for ensuring Seamless Service and Product Development

Source: Compiled by case writers from press reports.