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Airlines were global before much of the business world knew global existed. As early as 1919, Chalk's Ocean Airways was carrying passengers between Florida and the Bahamas in pontoon-bottomed seaplanes. That same year, regular flights between London and Paris began. By the mid-1930s, Pan Am was routinely flying to China, the Philippines, and Japan. International travel quickly became the most romantic, highest-margin segment of the airline industry, and it remains so today.

Given their rich international experience, you might think the major Western airlines — the so-called legacy carriers, like Delta Air Lines, British Airways, and Air France, among many others — would be well positioned to take advantage of globalization, now that other industries have caught up to them in seeing the profitability possibilities of worldwide commerce. But that's not the case; in fact, unlike for virtually every other industry, for the traditional airlines, globalization is not an opportunity, but their gravest threat.

For example, as auto, chemical, and pharmaceutical companies have demonstrated, this is a perfect time for international consolidation to better scale resources around the world. For large carriers, such mergers and partnerships could go a long way toward significantly cutting costs by reducing competition, using the workforce and planes more efficiently, and reconfiguring route networks to make them less redundant. But these global transactions are not in the cards. Although American Airlines and British Airways, for example, have tried to merge in the past, they called it off because the United States, like most other countries, puts strict limits on foreign ownership; in the U.S., no more than 25 percent of voting shares can be owned by non-American equity holders. (Europe remains the only continent where laws favor cross-border airline mergers, but that's primarily because Europe is akin to a single market with numerous small countries.) Because of these restrictions, international consolidation is effectively precluded for most large carriers, so they have to make do with local mergers, such as the recent Delta–Northwest and United–Continental deals in the United States. Those kind of linkups will help drive down costs in mostly saturated markets but do little to position the airlines to take advantage of potential growth in rising markets like India and China.

Ownership restrictions are just one set of leftover nationalist regulations that traditional carriers are forced to grapple with. Equally disconcerting and difficult to navigate are the sometimes inconsistent — or at least illogical — policies that governments impose in many countries. Take the route-by-route joint venture, a way that many airlines are using to get around rules against consolidation and M&A. Under this approach, airlines

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form service agreements with one another on specific routes and share the costs and profits equally. The joint venture partners cooperate on departure times, types of aircraft to use, distribution, and marketing. In so doing, they gain access to customers in regions where they are weak.

This concept was pioneered by Australia's Qantas Airways and British Airways in 1995 for the "kangaroo route" that links Australia and Great Britain over the eastern hemisphere. Antitrust enforcers allowed a five-year exemption for the deal in 1995 and have continuously renewed it since. However, approval of these partnerships is difficult to obtain in some countries. In September, the U.S. Department of Transportation denied a proposal by Delta and Virgin Blue to set up a route-by-route venture between Australia and the United States. Regulators felt that the deal unfairly favored Delta over rival United and balked at granting slots and landing rights to Virgin Blue on the West Coast. Thwarted by the Department of Transportation, Virgin struck a partnership deal with Abu Dhabi's Etihad Airways in which travelers can take Virgin flights from Australia to Abu Dhabi and board an Etihad plane to New York and Chicago.

At the same time that the legacy carriers struggle with navigating their international presence, the airspace itself is getting more crowded. New international players from the Middle East and nearby countries are emerging as a real threat with tangible advantages. Capitalized with government funds, running virtually tax-free, equipped with freshly built fleets of standardized aircraft, operating out of sparkling new airports, staffed with non-union workers, and offering top-notch service, these carriers — Etihad, Emirates, Qatar Airways, and Turkish Airlines, among others — are aggressively pursuing new economy-class fliers while skimming the business-class cream. They've been particularly successful at luring customers from traditional carriers on long international routes linking the developed world with emerging markets, especially between Europe and Asia. Indeed, Emirates is now the world's seventh-largest airline. Locations like Dubai are quickly becoming global megahubs. Most of these startup airlines are private companies, so information about the cost of operations is hard to come by. But given that employee strikes are illegal and collective bargaining unheard of in the Gulf States, it's easy to see the cost disadvantage the legacy carriers face.

Up against these new international challengers, and with rock-bottom-price discount carriers driving down yields in home markets, how can legacy carriers cope in an industry that for them will remain part protectionist, part globalized, for years to come? To begin with, while recognizing that there is no perfect business model for the airline industry, these carriers must commit to developing the optimal model for the markets in which they compete.

Airlines actually are conglomerations of several separate types of operations; these might include air service, maintenance, ground handling, and catering, among others. Although the outsourcing of functions such as aircraft maintenance, repair, and overhaul (MRO) has become routine, to one degree or another many airlines are still managing many of the other activities. For some airlines and when business conditions are particularly difficult, the steadier cash flow and reduced overhead from managing ancillary activities like IT, food distribution, and MRO in-house as shared services could be

Bring Back Free Aisle Seats!

by Daniel Röska

Large, established airlines are clearly facing challenges as they compete in a globalized environment — including the not-insignificant task of transforming their entrenched business models — and these efforts could take years to implement. In the short term, however, there are other steps that the airlines could take to improve their performance even as they navigate the future; unfortunately, few airlines are doing so.

In the face of intense competition for passengers and resulting low price levels — in part because of new and more nimble airlines chasing customers in domestic and global markets — the established carriers are striving to increase earnings by charging incremental fees for anything beyond the cost of air travel, including such basics as seat reservations and blankets. This unbundling of services has sparked an ugly backlash from travelers who are angry about absorbing what they view as hidden price increases and annoyed by having to decide at every step along their journey whether to pay extra for even the simplest service.

Instead of pursuing this path, the traditional airlines should consider a much more promising approach, smart rebundling, which has the potential to differentiate an airline's offerings from those of its competitors, restore goodwill with customers, and improve margins. Smart rebundling begins with parsing the air travel product into its individual elements, analyzing the cost and the willingness of different customer segments to pay for each element, and then creating new tailored offerings that closely match each customer segment's needs and perceptions of value. Global business travelers who pay top dollar for their tickets, for example, may want express security-line privileges. The owner of a small business flying on a domestic day trip, on the other hand, may be uninterested in having access to the airport lounge, but would be drawn to the convenience of a free voucher that could be redeemed at any airport coffee shop.

By targeting customer segments with specific service components that they prefer, the airlines could sift out unwanted low-margin services and increase revenue and margins. And by eliminating what travelers see as punitive policies that are diluting the customer experience, the airlines could offer a more appealing service, attracting consumers and building brand loyalty.

To implement this rebundling approach, airlines will first have to abandon the legacy definition of their "product" and take a fresh view from the customers' perspective — something that they have struggled with in the past but that will be imperative in the future

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a smart strategy. For instance, Lufthansa in-sources most operations at Frankfurt and Munich, its major German hubs, but outsources these activities at less-trafficked sites where it does not have critical mass. During the current travel recession, carriers with the most diversified operational holdings — besides Lufthansa, Emirates, and American Airlines — have consistently outperformed their direct competitors.

However, many airlines realize that they can't compete with outsourcers like Amadeus Inc. in airline information technology or General Electric Company in heavy maintenance, and thus can find no compelling reason to keep these activities in-house. Yet more times than not, the outsourcing deals don't provide the anticipated results, because the agreements tend not to be particularly well thought out, lacking strong incentives for cost improvement, for example. Instead, they're more like basic supplier contracts between a single airline and a provider.

Existing global alliances may offer a pathway for sharing some of these activities that should be outsourced in a way that makes a real difference to the carriers' bottom lines. These partnerships, which include familiar names like SkyTeam, Star Alliance, and Oneworld, took shape in the 1990s when it became clear that international mergers would be a nonstarter for a long time. They were formed under the clunky sobriquet "code sharing," which means one airline tickets a partner's flight as if it were its own, thus extending each network's reach and, in the process, boosting airline revenue. Although air transport regulators are casting an increasingly wary eye on route-to-route ventures, they have begun loosening antitrust enforcement on these global alliances. Such à la carte "antitrust immunity," for example, allows partners' marketing departments to share information about each airline's passengers. The next level of alliance synergy that airlines may be able to tap in the coming years to improve corporate performance could include joint parts and materials procurement, shared information processing, and cooperation on new product development. Thus far, though, these moves remain a pipe dream, in part because antitrust regulators are still giving immunity only gingerly, but also because consensus among all alliance members is difficult to achieve.

Until these alliances can routinely produce improved returns and greater efficiency, airlines should consider more bilateral and multilateral sharing arrangements that don't involve an entire group of airlines but achieve synergies on a smaller but still significant scale. Among those already under way is the Atlantic Plus-Plus agreement among United, Lufthansa, Continental, and Air Canada. This, in effect, turns their linked routes into a virtual airline and could point the way toward realizing the types of sharing programs that are harder to coordinate in the big alliances.

In addition, the major airlines must finally commit to remaking themselves and develop the capabilities they need to compete in their complex business environment. The airlines have faced this challenge for a long time, but too many remain burdened by incoherence between their strategic direction and the operating model and capabilities required to succeed. For example, many of the older carriers own regional feeder airlines that they depend on to funnel customers to their major route networks. But these smaller sisters — like American Airlines' American Eagle — are laden with nearly the same labor expenses and union rules as the legacy carriers, and thus are being undercut in cost structure and ticket prices by direct, non-union, point-to-point discounters like Southwest in the U.S. and Ryanair in Europe. Moreover, this low-cost competition is getting even stiffer, as the announced merger of Southwest and AirTran demonstrates. For the feeders to survive, they must finally adopt a business model that matches the segment of the industry in which they operate. That means a much lower cost structure and greater price flexibility. Meanwhile, the parent companies may do well to part with the feeders, because they have their own big issues to deal with: namely, to implement the skills, processes, and technologies that will enable them to operate as leanly and efficiently as possible while offering top-flight customer service, global route networks, up-to-date planes, and competitive prices. American Airlines, in fact, has been considering selling American Eagle.

Finally, although nationalistic politics have militated against serious cross-border consolidation in the airline industry, the economic forces of globalization are unlikely to allow preservation of the status quo in perpetuity. Over the next decade, the chances of major changes in political attitudes toward international airline mergers are high enough that every major player in the industry must prepare for them. Expertise in merging diverse cultures will become a crucial competitive challenge.

Integrating two companies is tough enough within the same country. International mergers only up the ante. Even same-continent pairings can present difficulties: When Air France and KLM merged, very different work ethics had to be balanced. In France, by law, employees cannot work more than 35 hours a week. In the Netherlands, working hours are more flexible. In addition, airlines must be prepared to handle the complexity created by mergers in such activities as management of ground operations and maintenance of different types of planes.

Politics might protect the industry for now. But airlines that fail to anticipate a fully globalized future risk grounding themselves. Imagination and creativity enabled them to take flight and cross the oceans nearly a century ago. Now the large, established carriers must dig deep to apply those same traits again. +

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