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The KLM Approach to Alliances

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A Quick Preface

KLM Royal Dutch Airlines could claim three things that other airlines could not: it was the world's oldest airline, having been established in 1919, it was the first to kickstart a wave of alliances in the industry, beginning with the Northwest collaboration in 1989 and, since its 2004 merger with Air France, it was part of the world's largest airline.

In April 2008, KLM was at an interesting juncture. On its home-base side of the Atlantic, the financial performance of its four-year old merger with Air France was surpassing expectations. On the other side of the Atlantic, its long-term partner, Northwest, had just announced its intention to merge with Delta Airlines subject to regulatory approval.[1] A year earlier, Delta and Air France had formed a joint venture; along with its other partners, Alitalia and CSA Czech Airlines, the four airlines had antitrust immunity.

Together, all airlines (including KLM and Northwest) had received tentative approval for a six-way antitrust immunity from the US Department of Transportation (DOT) to coordinate the capacity and pricing of all routes.[2] Observers commented that antitrust immunity and the pending merger between Northwest and Delta were precursors to effectively create the first truly pan-Atlantic airline.

[1] "Delta Air Lines, Northwest Airlines Combining To Create America's Premier Airline," Northwest Airlines Press Release, April 14, 2008, http://www.nwa.com/corpinfo/newsc/2008/pr041420081978.html, accessed May 5, 2008.

[2] "D.O.T. Proposes Approval Of Northwest Airlines Application For Six Way Antitrust Immunity," Northwest Airlines Press Release, April 9, 2008, http://www.nwa.com/corpinfo/newsc/2008/pr040920081974.html, accessed May 5, 2008.

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KLM's thirst for extending its network, growing its market share and ultimately increasing profitability formed the main impetus behind building alliances and actively pursuing mergers. Throughout its history, KLM had made several attempts to merge with other airlines and had participated in over 100 different alliances with airlines and related service firms, which ranged from small one-city pair collaborations to large-scale joint ventures. Over time, KLM had developed a structured approach to managing its collaborations with other airlines.

This case study aims to highlight major milestones in the development of the airline's alliances from the late 1980s to the present. It is structured in four main parts: the airline industry, KLM's history of alliances and merger attempts, the Air France-KLM merger, and KLM's approach to alliances.

The Global Airline Industry

The global airline industry has always garnered constant attention from governments, businesses, the media and citizens since it is one of the primary modes of long-distance travel; in 2006, airlines carried 2 billion passengers. About two-thirds of passengers took domestic flights and the remaining one-third traveled internationally. Despite the downturn in the airline industry after the terrorist attacks on September 11, 2001 in the US, the industry had posted compound annual growth of 6.5% in passengers and 8.7% in total market value since 2002. As of 2006, the industry was valued at $345.7 billion. Half of the value was attributed to the Americas and 28.4% and 21.1% was in Europe and Asia-Pacific respectively.[3]

Most analysts predicted growth of over 5% during the next five years as people continued to travel for leisure and business and different geographies continued to demand products from other countries. At the same time, economic slowdowns typically translated directly to lower airline revenues as people forewent vacations and businesses tightened travel and airfreight budgets. Consumers constantly compared the cost of taking flights to other modes of transportation. For domestic flights, passengers considered the cost, speed and convenience of flying versus automobiles, buses, ferries and trains. The construction of larger highways, the development of faster marine vessels and the installation of high speed trains all put downward pressure on airline demand. Other factors that worked against airline demand were apprehensions concerning personal safety and the effect of airline travel on climate change.

Since the 1980s, global airline industry development had been characterized by deregulation. Deregulation involved a series of changes including the loosening of restrictions on routes, frequency and fares as well as the granting of rights to fly for foreign carriers. Despite recent deregulation, insiders often highlighted that the industry remained highly regulated in several areas; for example, starting a new airline in most markets still required a great deal of paperwork and bureaucracy. In Europe, the first wave of deregulation occurred in 1987 prohibiting governments to have a say in fares. The next stage was the "Community Carrier" in 1993, which allowed an airline operating within the European Union (EU) to be eligible for flying rights on nearly all routes within the region. Finally, in 1997, an airline from the EU could operate in any other EU market without constraints on fares and capacity.[4]

Along with deregulation, cross-industry alliances proliferated throughout the industry. Whereas block seat arrangements (i.e., when airlines purchased and re-sold a "block" of seats on another

[3] "Global Airlines," Datamonitor, Nov. 2007.

[4] Air France Corporate Website, Competition, http://corporate.airfrance.com/en/strategy/competition/index.html, accessed Feb. 28, 2008.

airline's flight) and code-sharing agreements (i.e., when two or more airlines included their "codes" on a flight allowing them to include the other airlines' flight in their own network) had existed since the 1970s, the idea of creating cross-industry alliances dated back to KLM and Northwest's alliance in 1989 and the proposed four-way Wings Alliance including KLM, Northwest, Continental and Alitalia in the mid-1990s. In 1997, five major airlines – United, Lufthansa, Scandinavian Airlines System (SAS), Air Canada and Thai Airways International – came together to form Star Alliance. In 10 years, the alliance had grown to 17 members. Oneworld and Skyteam alliances followed in 1998 and 2000 respectively. The aim of each alliance was to strengthen each airline's position, allowing passengers to benefit from the expanded network and to receive benefits (such as collecting points for a frequent flyer program). See **Exhibit 1** for a list of the airlines involved in each of the industry's major alliances.

While the importance of "alliances" was paramount, the words "low-cost" had become permanently etched in the consciousness of airline executives everywhere. Starting with Texas-based Southwest Airlines, the low-cost movement had come into its own by offering passengers inexpensive flights and basic on-board service. The low-cost model was typically predicated on flying short point-to-point routes (instead of hub-and-spoke), utilizing secondary airports where the fees were lower, conducting bookings directly by Internet or phone to bypass costly travel agent intermediaries, cutting out complimentary snacks and beverages onboard, configuring the plane for optimal seating arrangements and ensuring fast turnarounds to maximize airplane usage. While the low-cost movement had spawned a number of new airlines (both by existing legacy carriers and by new entrants), the most successful European example was RyanAir with profitability amongst the highest in the entire industry.

For many other airlines, profitability was somewhat elusive. It was estimated that few of the world's airlines were profitable enterprises. In Europe for example, the average load factor of passengers was 69%. As a rule of thumb, the industry considered breakeven to require a load factor of 75%.[5] Carriers' three major costs were labor, fuel, and the capital investment for the aircraft. Labor costs usually represented between 20 and 40% of sales and depended on the efficiency of the airline and the average salaries in the country where the airlines had operations. Jet fuel, although not taxed under international treaties, was traded on the open market and therefore fluctuated. In recent years, the cost of fuel had steeply risen. For most airlines, fuel represented between 15 and 35% of sales. To mitigate risks of changes in jet fuel prices, airlines usually engaged in the trading of financial hedging instruments.

The capital cost of a new aircraft fell between $100m-$300m depending on the model, seating capacity, range and the details of the contract between the airline and the aircraft manufacturers. Nearly all commercial aircraft over 100 seats were made by either Boeing or Airbus and customized orders were usually placed several years ahead of delivery. As an additional cost to the capital outlay, carriers had to cover recurring maintenance fees and in the situation that they opted not to buy aircraft, rental fees. Other costs included airport landing fees, commissions to agents and financing charges.

KLM's History of Alliances and Merger Attempts

KLM was established privately in 1919. After World War II, nearly all European governments set up "flag carriers," either by buying into or creating national airlines; in the Netherlands, the Dutch government bought into KLM. Throughout its history, it pursued a number of firsts, such

[5] K. Boyfield, "Mergers Can't Save the Airline Industry," *The Wall Street Journal Europe*, Oct. 6, 2003, p. A11.