

## **ALLY OR MERGE-AIRLINE STRATEGIES AFTER THE RELAXATION OF OWNERSHIP RULES**

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**Abstract:** When talking about the motives behind airline alliances, most people will say that the main motivation is the rules of airline ownership in the Air Services Agreements and national laws. An airline cannot buy an airline in another country, should it want to do so. An interesting question to ask is without airline ownership rules, whether carriers will prefer mergers rather than alliances. As no two airline alliances or mergers are the same, this paper will compare the development, patterns and fundamental differences between these two strategies. It will then suggest ways in which airlines could select the most appropriate strategy to meet their own operational objectives once airline ownership rules have been relaxed.

**Key Words:** Strategic alliances, Merge, Consolidation

### **1. ALLIANCES: AN ALTERNATIVE TO MERGERS**

#### **1.1 The development of airline alliances**

According to Professor Oum (Oum, 1997), the first international alliance was formed in 1986 between Air Florida and British Island Airways. Air Florida fed US originating traffic to British Island's code-share flights on the London-Amsterdam route. At that time, the US DOT did not require any formal approval for international code-sharing alliances. However, in March 1988, the US DOT clarified its position on international alliances, stating that an alliance would not be approved unless it was covered in a bilateral agreement or otherwise brought benefits to the US, and unless the foreign country also allowed US carriers' code-sharing rights in its own markets. For example, Northwest and KLM were granted antitrust immunity by the US DOT in November 1992, shortly after the US and Netherlands signed an Open Skies agreement in September 1992. Another example is the granting of antitrust immunity to Lufthansa and United in May 1996, in exchange for the Open Skies agreement between the US and Germany in February 1996.

The most significant alliances in terms of network expansion are clearly those with a global scope. The current status of members in these global networks is summarised in Table 1.

Alliances however, are an artificial solution to an artificial problem, which is why they are unstable and why many have been abandoned. Table 2 shows the results of the Boston Consulting Group's 1995 and 1998 studies concerning the durability of airline alliances. A key finding is that the success rate for all categories of alliances has improved substantially in the 1995-98 period over the earlier three-year period.

Table 1. Major airline alliance groups in 2004

| Oneworld  | SkyTeam  | Star Alliance  |
|---|--|--|
| Aer Lingus<br>American Airlines<br>British Airways<br>Cathay Pacific<br>Finnair<br>Iberia<br>Lan Chile<br>Swiss<br>Qantas | Aeromexico<br>Air France<br>Alitalia<br>CSA Czech Airlines<br>Continental Airlines<br>Delta Air Lines<br>KLM<br>Korean Air<br>Northwest Airlines | Air Canada,<br>Air New Zealand<br>ANA<br>Asiana Airlines<br>Austrian<br>Bmi<br>LOT Polish Airlines<br>Lufthansa<br>SAS<br>Singapore Airlines<br>Spanair<br>Thai Airways International<br>United<br>US Airways<br>VARIG |

Table 2. Percentage of alliances having survived a given time

|                              | 1992-95 (%) | 1995-98 (%) |
|------------------------------|-------------|-------------|
| Overall alliances            | 38          | 68          |
| Equity alliances             | 73          | 81          |
| Non-equity alliances         | 26          | 62          |
| Domestic alliances           | 65          | 93          |
| Alliances within a continent | 59          | 68          |
| Intercontinental alliances   | 33          | 58          |

Source: Oum and Zhang (2001), Key aspect of global strategic alliances and the impacts on the future of the Canadian airline industry, *Journal of air transport management*, No.7, p288.

But what is driving this search for alliances? According to Professor Doganis (Doganis, 1998), there are four factors pushing airlines into transnational alliances. Firstly, to gain the marketing benefits of large size and network spread; secondly, to reduce costs; thirdly, to reduce competition on duopolistic routes; and lastly, to circumvent nationality rules in bilateral air agreements. Of all these factors, the last one is the most critical factor pushing airlines into developing alliance strategies.

## 1.2 Alliance objective

According to Bissesseur (Bissesseur, 1996), the objective of airline alliances can be analysed from two perspectives; supply (production) and demand (marketing). On the supply side, the objectives are to decrease production costs and to increase efficiency. The strategy is to combine certain of the partners' operations in order to decrease unit production costs and to increase the utilisation of resources, including facility sharing, labour sharing, capacity rationalisation and joint purchasing (Table 3). Demand side objectives consist mainly of accessing new markets, benefiting from traffic feed and increasing market power. Airline alliances enable airlines to satisfy their need to grow. The strategy includes code-sharing, block-sharing, franchising, schedule and fare co-ordination, FFP co-ordination and international hubbing.

Table 3. Alliance objectives

|            |             | Strategy                        | Advantages   |
|------------|-------------|---------------------------------|--|
| Objectives | Demand side | Code-sharing                    | <ul style="list-style-type: none"> <li>• Economies of scope</li> <li>• Economies of density</li> <li>• Market power</li> </ul> |
|            |             | Block-spacing                   |  |
|            |             | Franchising                     |  |
|            |             | Schedule and fare co-ordination |  |
|            |             | FFP co-ordination               |  |
|            |             | International hubbing           |  |
|            | Supply side | Facility sharing                | <ul style="list-style-type: none"> <li>• Economies of integration</li> <li>• Economies of scope</li> </ul>                     |
|            |             | Labour sharing                  |  |
|            |             | Capacity rationalisation        |  |
|            |             | Non-core activities             |  |
|            |             | Joint purchasing                |  |

If we analyse the objectives of an airline alliance from the revenue generation and cost reduction perspective, the detailed aim of each strategy can be uncovered. The strategy for revenue generation includes access to new markets, enhanced feeder traffic, joint marketing, technology and knowhow. Access to new markets can be achieved by an alliance via: interlining, block-spacing, code-sharing, franchising and provision of joint services (Table 4). On the other hand, strategies for cost reduction includes joint marketing, labour sharing, cross utilisation of fleets and shared facilities. The way to achieve labour sharing includes joint sales, joint ground handling, joint engineering and joint services.

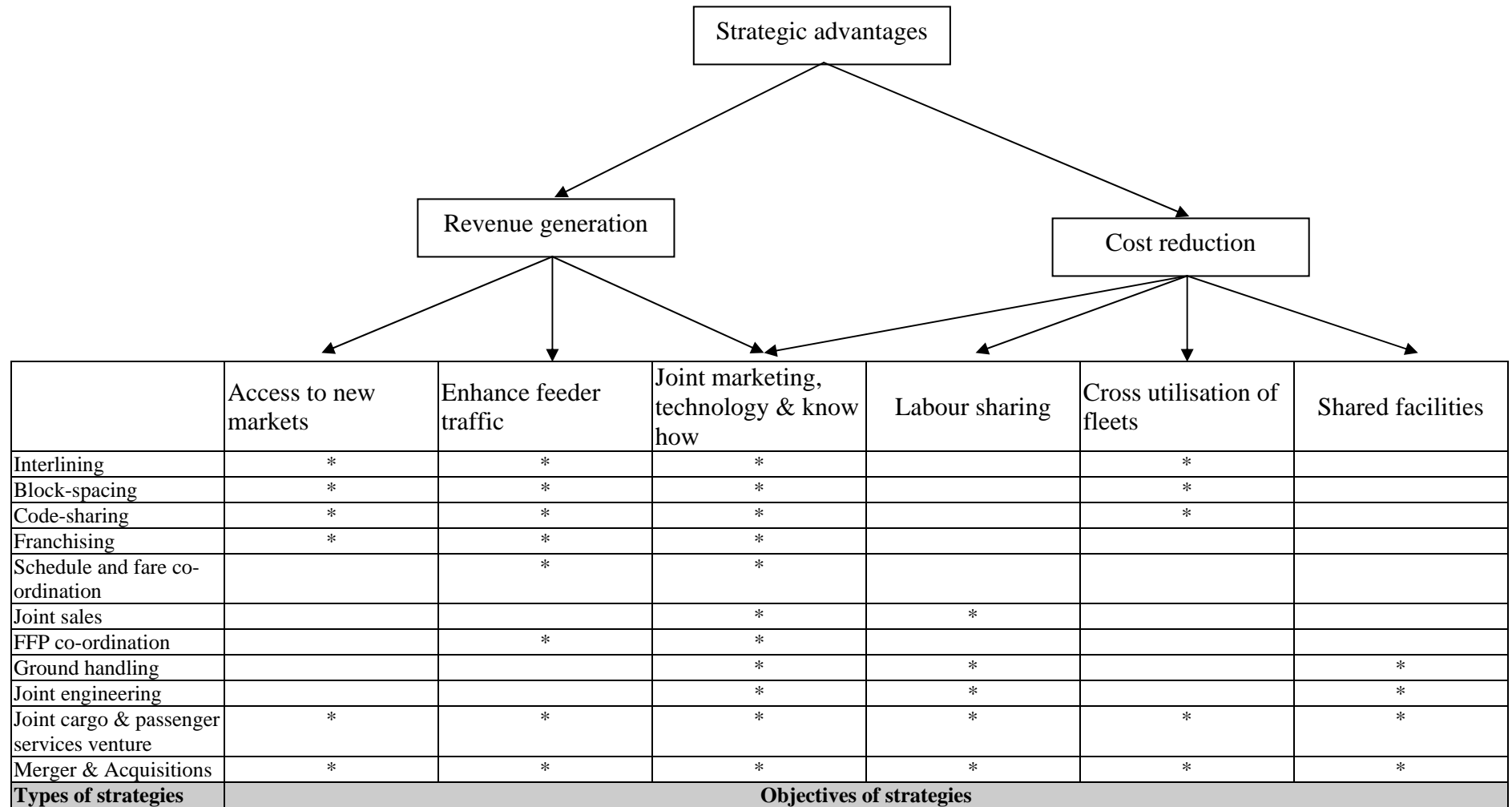
### 1.3 Types of alliance

Over the years a very wide range of complex inter-airline agreements has grown up to meet specific airline needs. As present the most prevalent form of alliance in the airline industry is code-sharing agreements. Although a co-operation can take many forms, most forms are combined with a code-sharing arrangement. Conceptually, the diversity of alliances can be related to the level of cohesion between the code-sharing partners. This level is reflected in (Berechmank,, Joseph and Jaap de Wit, 1999) :

- The network scope
- The commercial commitment of the non-operating carrier(s) in the alliance
- The degree of integration of the other components of the marketing mix
- The operational integration of the airline product
- Equity aspects of the alliance

Generally speaking, there are four types of alliance. The simplest is the point specific, in which airlines only code-share or blockspace purchase on certain city pairs (Table 5), as was the case with Qantas and Swissair, which used to code-share between Australia and Switzerland via Singapore. Another case is Air China, which has a blockspace agreement with Finnair on the Helsinki-Beijing route.

Table 4. Classification scheme for the objectives of airline alliances



The second type is the regional alliance, in which airlines code-share on several routes or franchise regional airlines. For example, Ansett and KLM are intercontinental route partners, which code-share between Sydney, Brisbane, Canberra, Melbourne, Adelaide and Cairns. Japan Airlines and Iberia have a code-share agreement on intra-European flights between Madrid, Barcelona and Amsterdam. Australia's domestic airline Impulse served as Qantas's franchise partner.

Table 5. The nature of airline alliances

| Items          | Content   |
|----------------|---|
| Point specific | <ul style="list-style-type: none"> <li>• Code-shares on small number of city pairs</li> <li>• Often with block space purchase</li> </ul>                                |
| Regional       | <ul style="list-style-type: none"> <li>• Code-share on several routes to-from specific region or franchising of regional airline</li> </ul>                             |
| Global         | <ul style="list-style-type: none"> <li>• Code share vast number of routes</li> <li>• Linking of two major hub networks</li> <li>• Wider commercial agreement</li> </ul> |
| Strategic      | <ul style="list-style-type: none"> <li>• Only if there is effective co-mingling of assets</li> </ul>  |

Source: Rigas Doganis, *Airline industry: problems and prospects*, Air transport management seminar, Cranfield University, 8-12 November 1999.

The third type is the global alliance, in which airlines code-share vast numbers of routes, linking two major hub networks, in a wider commercial agreement. One example is Singapore Airlines, Thai Airways, All Nippon Airlines, Air New Zealand and Ansett, which are Star Alliance partners in Asia-Pacific. Cathay Pacific and Qantas are Oneworld's partners in this region.

The last type is the strategic alliance. According to Professor Doganis (Doganis, 2001), a strategic alliance is one where the partners co-mingle their assets in order to pursue a single or joint set of business objectives. Co-mingled assets may be terminal facilities, maintenance bases, aircraft, staff, traffic rights or capital resources. If two or more airlines offer a common brand and a uniform service standard then they are co-mingling their assets and have moved into a strategic alliance. Many franchise agreements are of this kind. British Airways' franchise agreement with Maersk Air UK, Comair, Loganair and Base Airlines are examples of this type of alliance.

#### 1.4 Factors affecting alliances

From an economic perspective, limitations to alliances can result from several sources; regulatory constraints imposed by overseeing agencies, changes in technology, trends in the demand level, supply-side factors, such as scale, scope and network economies, and market organisation determinants such as the nature of competition (Table 6) (Berechmank, Joseph and Jaap de Wit, 1999).

Table 6. Economic factors affecting alliances

| Factors                     | Influences   |
|-----------------------------|--|
| Regulatory effects          | <ul style="list-style-type: none"> <li>• State or market regulation</li> <li>• International treaties</li> <li>• Antitrust legislation</li> <li>• Non-uniform environment regulations</li> <li>• Non-uniform airport charges</li> </ul>  |
| Technology                  | <ul style="list-style-type: none"> <li>• Aircraft type</li> <li>• ATC</li> <li>• CRS</li> <li>• Baggage handling</li> </ul>  |
| Demand factors              | <ul style="list-style-type: none"> <li>• Longitudinal trends</li> <li>• Geographical distribution</li> <li>• Preferences (price, travel time and frequency elasticities)</li> <li>• Competing modes (e.g. rail)</li> </ul>   |
| Supply-side factors         | <ul style="list-style-type: none"> <li>• Horizontal integration between airlines</li> <li>• Economic complementary in production: network integration</li> <li>• Common (shared) factors of production</li> <li>• Demand complementarity</li> <li>• Global network economics</li> <li>• Product (scope) economies</li> </ul> |
| Market-organisation factors | <ul style="list-style-type: none"> <li>• Effective market entry barriers</li> <li>• Effect of hub-and-spoke networks</li> <li>• Market entry by new start-ups</li> <li>• Anti-trust immunity</li> <li>• Extent of network economies</li> <li>• Market equilibrium and stability</li> </ul>                                   |

Source: compiled from Berechmank, Joseph and Jaap de Wit, 1999. In Gaudry, Marc and Mayes, Robert, 1999. *Taking stock of air liberalisation*. Kluwer Academic Publishers. p.256-279.

Fear of monopolistic behaviour, or attempts to protect state interests induce many countries to adopt regulatory measures which limit the extent of cross-border co-operation between airlines. These restrictions are demonstrated in issues like airline ownership, code-sharing in bilateral Air Services Agreements, and competition policy. Economies of fleet standardisation can have a major effect on the competitive position of alliances, by for example cutting the maintenance and labour costs. Information technology and the development of CRS have emerged in the distribution of the airline product. Code-sharing had its origins in the CRS screen priority rules in the US domestic market. ATC and baggage handling technology are very important for hub efficiency. In general, demand is affected by air fares and travel time. Whether the alliance can reduce the air fare will depend on the relationship between deregulation, network structure and competition. But the major result of an alliance is the significant increase in frequency, which greatly reduces waiting times for departing passengers. The geographic distribution of demand also has a major impact on the attractiveness of alliance partners. For example, the location of Bangkok Airport is the major reason for Thai Airways becoming a founding member of the Star Alliance. For supply-side economics, network integration of two individual airlines is the main effect. This means that two airlines must share a common factor of production, operation from the same airport, sharing facilities and labour. For market organisation, airline co-operation between

incumbents through expansion or combination of hub and spoke networks strongly affects market entry barriers and competition between incumbents and new carriers. As airport slots are still limited by grandfather rights, it is difficult for new entrants to compete with the existing incumbents (Berechmank, Joseph and Jaap de Wit, 1999).

## **2. THE EFFECTS OF ALLIANCES AND MERGERS**

There are strong incentives for consolidation. The demand and cost side economies of scale and scope give larger airline networks a competitive advantage over smaller carriers. Airline mergers and alliances can allow airlines to lower costs and enhance demand by rationalising the combined networks and expanding the scope of seamless services. On the other hand, airline mergers and alliances can reduce competition and enhance market power, especially on non-stop routes to and from hub airports. Generally, the advantages of alliances and mergers can be summarised as follows:

- Economies of scale, scope or density
- Market power
- Globalisation
- Network integration
- Access to partner's hub
- Access to technology and other resources
- Resource sharing
- Operational flexibility
- Reducing competition
- Product/service diversification

In the academic field, a great deal has been written about the effect of alliances and mergers. As the level of effect differs widely between city-pair markets and between different classes of consumers in each case, this section will compare the general advantages and disadvantages of alliances and mergers.

The relative balance of the benefits in terms of efficiency and the effects on competition depends on a number of factors, including the degree of overlap in the airlines' networks prior to the merger. A merger of two networks which do not overlap has the potential to enhance efficiency at the risk of reducing the number of potential entrants into the network's markets. In the case of international alliances, regulatory restrictions prevent competitive entry by a foreign airline into a domestic market, so an alliance between two non-overlapping networks has fewer anti-competitive effects. A merger or alliance of two overlapping networks has significantly greater potential for anti-competitive effects, especially on overlapping non-stop (hub-hub) routes and overlapping connecting routes.

Apart from the airline ownership rules, there are many other regulatory barriers to airline acquisitions and mergers. These arise primarily from attempts by governments to avoid anti-competitive behaviour or the abuse of a dominant market position. The drive for consolidation in the airline industry also represents a potential threat to that competition. Although certain mergers and alliances can lead to substantial benefits to consumers, there is also a strong possibility of important restrictions on competition, especially on overlapping routes and, more particularly, on hub-hub routes. Regulations exist in most developed countries aimed at ensuring that competition is not distorted. Such regulations may be enforced directly by

governments and/or by special competition authorities, such as the Department of Justice and Department of Transportation in the US, or the Bundeskartellamt in Germany. In the US, both the DOJ and DOT have a say in domestic airline mergers. For example, in September 1971, while the Northeast-Delta case was pending, the Secretary of Transportation announced “Executive Branch criteria” for evaluating airline merger proposals, as follows: (Lowenfeld, 1972).

- A merger should not result in either the elimination of effective competition, or an excessive market share for the surviving firm, in significant city-pair regional or national markets for air carrier services.
- A merger should not result in undue concentration within the air carrier industry.
- A merger should not be likely to lead to extensive reactions and defensive merger proposals by competitive carriers so that the end result will be a restructuring of the industry and excessive concentration in a few firms.
- A merger should not result in substantial foreclosure of competition for interchange traffic or other excessive injury to other carriers.
- A merger should bring about substantial operational, service, or organisational benefits for the surviving firm so that the public will receive significant benefits such as greater efficiency and better service, and the size of merged air carrier firms should not be such as to produce significant diseconomies.
- In the case of a merger of a relatively effective carrier and one that is marginal, or in the case of the two marginal carriers, the resulting benefits of the surviving firm should be corrective of the original difficulty of the weaker merger partner. Alternative solutions to the problems of a marginal merging carrier should be shown to be considerably less effective than merger.
- The protection afforded to the labour force in the merging firms should be in accordance with the present policies of the CAB.

### 3. DIFFERENCES BETWEEN MERGERS AND ALLIANCES

If firms are seeking to achieve economies of scale, a merger or fully-fledged acquisition will allow for a greater rationalisation than will an alliance. The whole purpose of a planned merger is precisely to take the rationalisation process further, closing down less efficient facilities, reorganising the product lines in a consistent way, etc. This is the reason why British Airways was keen to merge with KLM in 2000. British Airways is by far the largest European airline in terms of RPK, but is only about half the size of United Airlines and American Airlines. A merger of these two airlines could make BA the world’s third largest airline, while also making huge savings in costs (Table 7).

Table 7. The objectives of the BA/KLM merger

| BA  | KLM   |
|---|---|
| <ul style="list-style-type: none"> <li>• Establish BA as the world’s third largest airline</li> <li>• Substantial cost savings</li> <li>• Access to KLM’s Amsterdam Schiphol hub</li> <li>• Get a transatlantic partner Northwest</li> <li>• Pass low yielding transfer traffic over</li> </ul> | <ul style="list-style-type: none"> <li>• Cost savings</li> <li>• Access to BA’s Heathrow hub</li> <li>• Expand its market from BA’s mixed traffic</li> <li>• Strengthen its position</li> </ul> |



|        |  |
|--------|--|
| to KLM |  |
|--------|--|

The main difference with an alliance is that collaboration will be limited in scope and effectiveness as a result of two factors:

- All decisions must be made by consensus among the partner firms
- Alliances are transient in nature and must remain reversible.

Because they are placed under the simultaneous authority of several partner firms, alliances tend to lead to virtually unending rounds of negotiations (Garette, Vernard and Dussauge, Pierre, 2000). Within the framework of a newly merged company, differences of opinion about decisions to be made can be arbitrated by the senior management of the acquiring firm. In an alliance, however, one of the parties cannot force the other to accept any particular solution. By bringing together several companies which, despite the agreement between them, remain independent entities, alliances imply that multiple decision-making centres will be involved in the choices to be made about the joint project or activity. The multiplication of decision-making centres makes it considerably longer and more complex to make decisions on controversial issues. Indeed, to become effective, every such decision requires the agreement of all the partner companies involved. In certain cases, the lack of agreement between the partners can even paralyse the alliance for considerable lengths of time and delay the implementation of badly-needed rationalisation measures. After having disagreed for many years on how to manage and turn around the company, it may still take the partner firms several years to terminate their joint venture.

A second major characteristic of alliances is their transient nature. By definition, it has to be possible to terminate alliances without putting the partner firms at risk. One of the basic justifications for choosing alliances over more permanent forms of organisation is precisely that they can be undone relatively easily. One such case was when Singapore Airlines revoked its alliance with Delta and Swissair in 1998 after ten years' co-operation, before joining the Star Alliance. The other was Austrian Airlines, which abandoned a 44 year relationship with Swissair in order to join the Star Alliance.

For mergers, one of the major pitfalls is the post-merger integration process. Alliances make it possible to avoid the cultural and organisational shocks which come in the wake of an acquisition, by proceeding step by step and by gradually adapting the content and structure of the agreement. The multitude of integration problems that inevitably arise as a result of a merger mean that the companies involved must be prepared for distractions from performance and the triggering of unexpected human emotions, as previously separate organisations come together. Combining two into one is an extremely difficult task (Marks, Mitchell Lee and Mirvis, Philip H., 1998).

The other major disadvantage of mergers is that it is not a riskless investment, and requires capital to invest. If the partner airline gets into financial difficulties this will obviously reduce the market value of the stake, and in the extreme circumstance of the partner declaring bankruptcy and ceasing operations, the investment may have to be written off altogether (Hanlon, 1999). This was a significant factor in the cases of Swissair and Air New Zealand recently. Swissair's acquisitions in Sabena, LTU, Air Europe, Air Littoral and Air Liberté-AOM caused Swissair substantial harm, leading to its bankruptcy in October 2001. The operating loss of Air New Zealand's fully owned subsidiary Ansett Australia not only brought about its own bankruptcy, but also resulted in its parent company Air New Zealand being

taken over by the New Zealand Government. The general differences between mergers and alliances are summarised in Table 8.

Table 8. Advantages and disadvantages of mergers and alliances

| Mergers  |   | Alliances  |  |
|--|---|--|--|
| Advantages   | Disadvantages   | Advantages   | Disadvantages  |
| <ul style="list-style-type: none"> <li>• Full integration of network</li> <li>• Control of partner</li> <li>• Concentration on profitable routes</li> <li>• Cost savings</li> <li>• Rapid decision making</li> </ul> | <ul style="list-style-type: none"> <li>• Difficulties in post-merger integration</li> <li>• Antitrust restrictions</li> <li>• Need capital for purchase</li> <li>• High risk</li> </ul> | <ul style="list-style-type: none"> <li>• Undone relatively easily</li> <li>• Easier to find a partner</li> <li>• Low risk</li> </ul> | <ul style="list-style-type: none"> <li>• Consensual decision-making process takes longer</li> <li>• Must remain reversible</li> <li>• Partners' goals may be different</li> <li>• Cannot force partners to accept any particular solution</li> <li>• Partners might be purchased by a rival</li> </ul> |

#### 4. SUMMARY AND DISCUSSION

Since the deregulation of the US domestic transport markets, the transport industries have witnessed major reorganisation. Average firm size and aggregate industry concentration have increased considerably over the past decade. Many airlines failed and were taken over by others. Small airlines merged with larger airlines, and the larger ones consolidated to form mega-carriers. By allowing industries to consolidate unchallenged, policy-makers appear to believe that in a deregulated environment, larger size may have advantages in productive efficiency (Oum and Zhang, 1997).

Strategic alliances present complex management and co-ordination situations. While it is always in an airline's interest to define its objectives carefully, the more powerful partner should view alliances from a portfolio perspective. Its goal should be to align itself with various partners that offer, in combination, the greatest potential for traffic feed, economies, access to new markets and defence of current ones (Thomas, 1997). An example of this strategy is the Star Alliance group headed by United Airlines, which, by adding Varig of South America as a partner in late 1997, attained its objective of becoming the first global airline alliance. The new aviation markets include South America, with Varig Airlines seeking to exercise a dominant role, and China, where Cathay Pacific and China Eastern Airlines dominate. Yet the future remains uncertain in the new millennium. What is clear, however, is that the dominant carriers, United Airlines, American Airlines, British Airways, Delta, Continental, Lufthansa and Singapore Airlines will continue to assert themselves on a global scale, and the smaller carriers will seek alliances with one or more of the major groups, or risk ultimate demise (Simons, 2000).

However, many of the speakers at the Phoenix Symposium in May 1999 argued that alliances were better than mergers or takeovers, because of the difficulties of integration, illustrated by past history; on an international scale those difficulties would be exacerbated by cultural

differences. But, right alongside the airline alliance frenzy is a parallel process of mergers and acquisitions on a global scale in other industries: banks, oil, telecommunications and car manufacturing. Much of this is driven not so much by access to markets, but by the simple fact that some companies have better management, higher productivity and greater access to capital than others. Given the opportunity, the stronger absorb the less well endowed and put their assets and their markets to better use.

What we learn about airline industry in a multilateral world is when ownership rules begin to be relaxed, a new period of instability and change may occur as cross-border mergers begin to replace the traditional alliance agreements. Old partners may be abandoned and new partnerships created. Furthermore, the gradual privatisation of state-owned airlines will also bring these airlines into play. The better ones will also become acquisition targets and alliance partners. As mentioned in Sections 1.2 and 1.3, alliances and mergers both have their risks and side-effects. However, the recent cases of Swissair and Air New Zealand have shown that bad investment may lead the parent company into bankruptcy, and the recent economic downturn will allow many airlines with capital to purchase others.

As Drucker has said, "Business growth and business expansion in different parts of the world will increasingly not be based on mergers and acquisitions or even on starting new, wholly owned businesses there. They will increasingly have to be based on alliances, partnerships, joint ventures and all kinds of relations with organisations located in other political jurisdictions. They will, in other words, increasingly have to be based on structures that are economic units and not legal - and therefore not political units." (Peter F. Drucker, 1999).

For an airline, the most important thing is clarifying the corporate mission, in order to achieve its long-term objective, either to be a global network carrier or a niche player. A global airline would aim to provide a world-wide network of routes and destinations. It can do this by linking its own wide route network with alliance partners through their hubs, or acquiring feeder carriers for their regional networks, as was the case with British Airways and Singapore Airlines. British Airways joined the Oneworld global alliance for the global network, and keen to get anti-trust immunity for the transatlantic alliance with American Airlines, it also purchased regional carrier Deutsche BA for access to the German market. Singapore Airlines, a member of the Star Alliance, also acquired 49% of Virgin Atlantic for Trans-Atlantic routes, and 25% of Air New Zealand for Pacific routes. Ally or merge? The right option is dependent upon the carrier's objective.

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