UNITED AIRLINES, INC.'S SUBMISSION

TO THE

INDUSTRY COMMISSION

INTERNATIONAL AIR SERVICES INQUIRY

FEBRUARY 1998

UNITED AIRLINES, INC.'S COMMENTS

United Airlines would like to thank the Industry Commission for affording the company this opportunity to participate in the Commission's inquiry into international air services.

This inquiry comes at a particularly opportune time. Most of the world's airlines are replacing the linear route systems that have characterized the air transportation industry since the days of the Wright Brothers with hub-and-spoke networks and global alliances. As this process continues, it is widely expected that the old concept of operating almost exclusively within and between a carrier's homeland and abroad on a point-to-point basis, will give way to the marketing of a worldwide product, regardless of whether the marketing carrier actually flies the route itself. Global alliances make travel more convenient for international passengers by providing single-carrier service for all of their travel needs. These alliances allow airlines to offer travelers a coordinated network of hassle-free connections to virtually all points on the globe, making international travel more convenient, and often quicker, for the global travelers.

In order for a truly global aviation market to emerge, however, two essential supporting elements must be in place: a broad "open skies" regime that guarantees open pricing and liberal access to any market in the world for all carriers, and a correspondingly broad acceptance of airline marketing alliances. The pattern of narrowly drawn bilateral air transport agreement upon which international aviation currently is built is clearly not suited to facilitate the development of such a global market. For that reason, an increasing number of countries around the world have recognized that replacing their old bilateral agreements with new open skies agreements, thereby widening their transportation access to the global market and exposing their flag carriers to open competition, is a better way to secure more overall economic benefits for their carriers, consumers, and national economies than protecting the carriers from competition ever was. If Australia is to enjoy fully the full range of economic benefits available from the increasing globalization of the air transport industry, it will need to consider significant liberalization in many of its bilateral relationships, particularly its relationship with the United States, in order to liberalize entry into Australia's international air travel market, and open the way for Australian carriers to participate fully in global alliances.

The foundation for the current bilateral structure on which international aviation is premised was laid over 50 years ago during the period between the Chicago Convention of 1944 and the negotiations in 1946 between the United States and the United Kingdom, which led to the so-called Bermuda Agreement. During this period, world governments debated the future of international aviation along two very divergent paths: "Freedom of the Skies," along the same lines as the freedom of the seas that has characterized international shipping for generations, versus a reciprocity based mercantilism in which governments exchanged specific "freedoms" in negotiated, bilateral agreements. The path chosen at Bermuda, to cabin the development of international aviation within a narrow exchange of freedoms, has led over time to an increasingly rigid and protectionist operating structure in which the interests of consumers, air travelers and shippers, is largely sacrificed to the interests of the producers of air transport services, the carriers.

With the increasing globalization of the world's economy, this rigid pattern of reciprocally balanced exchanges of operating rights has proved to be inadequate for the development of an international aviation industry that could meet the needs of today's global air travelers. To respond to these needs, governments have begun to replace bilateral air transport agreements built on protectionist, mercantilistic principles with a range of more open regimes, including an essentially deregulated air transport market within the European Union, a nearly deregulated market between Australia and New Zealand, the nearly [25] open-skies agreements the United States has negotiated with selected trading partners throughout the world, including New Zealand, and many other moderately liberalized agreements between many pairs of countries.

Among the outcomes these new regimes have produced, none is more important for the future development of the global economy than the strategic alliances that have arisen between major international airlines. As these alliances develop, they portend a new era of international aviation development that will change the human condition at least as much as the aviation industry has already done. If governments continue to take the steps necessary to facilitate these alliances, the prospect is close at hand for a world in which nearly any middle class person could affordably travel via a global network of allied carriers from virtually any place in the developed (or developing) world to almost anywhere else in the world, making no more than two connections en route, enjoying all the benefits of single-carrier service and responsibility, and having the opportunity to choose between the schedules and services of competing alliances.

We live in an era in which air transportation generates global advantages and benefits that transcend the narrow interests of any one country or carrier. Aviation is now the engine for economic growth and prosperity around the world. The availability of efficient air transportation services is essential to facilitate every country's expansion of its international commerce and ability to participate in the global marketplace. Global alliances play a key role in providing this network of efficient air transportation services and reflect carriers' response to three factors influencing the industry: The traveling public's strong preference for single-carrier service, the economies of scope and scale hub-and-spoke operating systems make possible, and the ownership and control limitations that continue to restrict trans-national investment in the industry.

Since the deregulation of the domestic U.S. air transport industry in 1978, there has been a radical transformation of airline route structures into hub-and-spoke configurations. The great advantages of such networks are now widely recognized: The combining of local traffic -- i.e., origin and destination traffic -- from and to the hub city with through traffic from each of the spoke end points to each of the other end points, via the hub, permits the use of larger, more efficient planes, the achievement of higher load factors and the offer of a much wider range of destinations to all travelers than were possible with the linear route systems that were typical under regulation.

Hub-and-spoke operations also exhibit economies of both scope and scale. Economies of scope arise from the fact that the more spokes a carrier serves from a hub, the greater its ability, with a given number of aircraft, to transport passengers from many origin points to many destinations. For example, assume five cities arrayed north to south along a line east of a hub and five cities correspondingly arrayed to the west, with just 10 airplanes, five moving in each direction, a carrier can serve a total of 70 city-pair combinations by operating via a hub, versus only 10 at a time if operating a linear network.

Economies of scale arise because by expanding the number of spokes, the number of city-pair combinations that can be served increases exponentially. For example, if the number of cities served on each side of a hub increases from five to nine, and the number of airplanes in use from 10 to 18, the number of on-line connections that can be offered increases from 70 to 198. Thus, a less than 100% increase in cities served produces a more than 100% increase in travel options.

These economies, when coupled with travelers' strong preferences for on-line versus interline connections, have provided carriers a strong incentive to organize their route network into hub-and-spoke systems. U.S. carriers were the first to recognize these operational and service efficiencies and, thus, were the first to develop hub-and-spoke networks. The development of these networks had profound effects, not only on competition in U.S. domestic markets, but in the international marketplace as well.

In international air transportation, airlines can establish hubs in foreign countries in two ways: they can operate the local spokes from the hub with their own aircraft pursuant to whatever traffic rights ("beyond rights") their government has negotiated for them, or they can enter into code-share agreements with the foreign carrier for whom the gateway airport serves as a hub. Under this type of arrangement, the foreign carrier operates the spokes on behalf of the other airline.

Historically, all airlines opted for the first method, using their beyond rights and operating their aircraft beyond foreign gateways to other points in the region. The range of earlier aircraft made a stop at a primary gateway essential in serving the more distant points on long-haul intercontinental routes linking, for example, North America with Europe or Asia, or Australia with Europe or North America. In addition, for many years, non-U.S. carriers had little in the way of hub operations upon which other carriers could rely for connecting feed traffic.

This historic approach to network development began to change in the early 1980's as U.S. carriers, freed of economic regulation in the U.S. domestic market, began to expand their online networks into more international markets. At the same time, the process of deregulation was getting underway within the European Union, opening the opportunity for the major European carriers to develop hub-and-spoke networks similar to those being developed in the United States.

As both U.S. and European carriers were moving to expand their networks, they turned to alliances as an alternative to the traditional method of operating beyond services because legal and other obstacles prevented them from developing an integrated multi-hub route network on a global scale as efficiently through internal growth or mergers as they could through alliances. These obstacles included not only the various restrictions in bilateral agreements -- particularly the limitations on cabotage, foreign ownership and fifth-freedom service -- but also the enormous costs involved in setting up a meaningful hub in a foreign country.

Effectively blocked from merging, and precluded from expanding by internal growth alone due to the costs involved and bilateral limitations, major international carriers have chosen to enter into global alliances with other international carriers as the best means available to continue their global expansion, and to gain the economies of scope and scale available from hub-and-spoke networks on a global scale. With government regulation of carriers' operating authority ending, global alliances provide carriers a superior alternative to interline transportation under the auspices of IATA's multi-lateral interline agreement to respond to passengers' preference for online travel, with single-carrier responsibility, through ticketing, through check-in, coordinated flight schedules, and the ability to accrue (or redeem) frequent-flyer miles in a single program.

This is amply demonstrated by developments that have occurred in the transatlantic market. It was there that Northwest and KLM pioneered the use of a code-sharing multi-hub network as an alternative to operating their own beyond gateway flights. The successful Northwest-KLM code-sharing alliance was quickly followed by others, including United's alliance with Lufthansa and SAS, and Delta's alliance with Austrian, Sabena and Swiss Air, as well as the alliance proposed between British Airways and American, which is still awaiting governmental approval.

One of the key elements underlying these alliances (except the pending American/British Airways alliance) is that the U.S. Department of Transportation has granted the parties immunity for U.S. antitrust laws to permit them to operate as if they were a single firm. This facilitates the parties' ability to coordinate service over their respective networks and to achieve all of the efficiency gains possible from joint operations. The United States has been prepared to grant such immunity only in circumstances where there is available both de jure and de facto open entry into the air transport market between the U.S. and the foreign country concerned. To ensure de jure entry is available, the U.S. has insisted that the homeland of any foreign airline seeking immunity from U.S. antitrust laws for an alliance with a U.S. airline enter into an open skies aviation agreement with the United States.

Most aviation analysts agree that the global integration of air carrier route networks through alliances is the direction in which this industry will continue to move. If these observers are correct, carriers serving Australia will want to expand their reliance on code-sharing on services to and from Australia to assure that the carriers' Australia services are fully integrated into their global route networks.

All of these factors suggest that in developing a new international air transportation policy, Australia should give primary consideration to liberalizing its aviation bilaterals, where appropriate, to ensure that Australian carriers will be positioned to become an integral part of the growing trend toward global alliances, and to ensure that Australian consumers will enjoy all of the competition and service benefits that inevitably result from competing alliances being able to serve key points throughout Australia. Code sharing will, obviously, have to play an important role in securing these benefits for the Australian consumer, the country's global economy, and its flag-carriers. For this to occur, Australia will need to consider revisions to many of its bilateral relationships, including its aviation agreement with the United States, to liberalize entry and facilitate Australian carriers' ability to participate fully in the development of global alliances.

s:\asia\austral\1998\australi.doc