

## **SURVIVING THE SINGLE MARKET:**

### **The dilemmas and strategies of “small-country” airlines**

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#### **SUMMARY:**

This paper examines the problem of the survival of national “flag carrier” airlines of smaller Member States of the European Union in the increasingly competitive environment of the single European market. After considering the particular features of smaller countries as aviation markets, it discusses the advantages and disadvantages experienced by airlines based in such countries under the current international regime for commercial aviation (the so-called Chicago system). The paper then analyses the strategic responses of selected airlines (mainly Aer Lingus, Finnair, KLM Royal Dutch Airlines, Sabena, SAS and TAP Air Portugal) to the challenges of the single market. In particular, it explores efforts to establish global systems, to create European and long-haul niche markets and to form protective alliances between “small-country” carriers. The paper concludes by noting the tendency for the surviving national airlines of smaller Member States to become incorporated into the current global airline alliances as junior partners and the reasons for their accepting this status.

#### **Introduction:**

Ever since the beginning of commercial aviation in Europe, observers have deplored the multiplicity of national, “flag carrier” airlines. In 1918, Alfred Instone - the founder of one of the first British airlines - warned of the dangers that nationalism posed for the growth and efficiency of the new industry: it was, Instone argued,

impossible to control the air services of Europe on nationalist lines. You cannot have nearly forty sovereign countries each trying to wreck the air services of the other thirty-nine. Europe must be one area for air transport under one control, or there can be nothing but a few ferry services in operation.<sup>1</sup>

More recently, airline executives, European Commission officials and journalists have predicted

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that the European airline industry will inevitably undergo consolidation into three or four “mega-carriers” in place of the fourteen national “flag carriers” that now exist. Such consolidation would naturally begin - the argument goes - with the collapse of airlines based in countries that offer small markets and that cannot command the resources needed to sustain a carrier in the face of serious challenges from its larger and richer competitors. The collapse of two “small-country” carriers (Sabena of Belgium and Swissair of Switzerland) and the financial troubles of others (such as Aer Lingus) have encouraged the belief that consolidation is imminent.<sup>2</sup> The present Commissioner for Transport and Energy, Loyola de Palacio, reportedly believes that consolidation is desirable in order to enhance the competitiveness of European airlines vis-à-vis their American and Asian competitors.

But consolidation has not occurred. Between 1946 and 2001, not a single national airline disappeared (and, indeed, the bankruptcies of the Belgian flag carrier Sabena and of Swissair in 2001 were quickly followed by the constitution of two new airlines with curiously similar names).<sup>3</sup> “Flag carriers” based in the smaller European countries have in fact shown great resilience. Though they have become involved in global alliance systems (and have been involved in endless negotiations over more regional associations), they have frequently - and successfully - asserted their determination to keep their independence.

How have these airlines been able to survive in the face of competition that had been increasing on long-haul routes since the nineteen-sixties and that has intensified with the implementation of the three EU air transport liberalization “packages” between 1989 and 1997?

### **Size, markets and location:**

First, what do we mean by “small” or “smaller”? When does size matter, and why?

Small in this context may refer to territorial size: it may also refer to population and to the size or potential size of a market. Territorial size matters because air transport normally only becomes competitive on routes of 300 miles or more. But natural barriers such as mountains or stormy seas can improve the competitiveness of air transport dramatically (as the survival of the two-minute services between Westray and Papa Westray in the Orkney Islands shows).<sup>4</sup>

But the countries examined here are strikingly different in physical area: those physically smaller (such as Belgium, Denmark, Luxembourg, the Netherlands and Switzerland) offer virtually no viable market for domestic air transport, unlike the four largest (Finland, Greece, Sweden, and Norway). The “smallness” of the latter countries therefore refers more to population than to territory.

Smallness of size and population has not of itself stopped smaller countries from creating large airlines. At first sight, physical size might seem to be an absolute constraint: in the Benelux countries, for example, the scope for air services in competition with road and rail travel is

TABLE 1. SMALL-COUNTRY FLAG CARRIERS: OWNERSHIP, TRAFFIC, STAFF AND AIRCRAFT

<u>Airline:</u>	<u>Degree of state ownership</u> (1996)	<u>Passengers carried</u> (1998) (000)	<u>Employees</u> (1998)	<u>Aircraft in fleet</u> (1998)
Aer Lingus	100%	5,506	5,620	38
Austrian Airlines	51.9%+ 15.0% public shareholders	4,393	5,464	34
Finnair	60.7% + 4.9% publicly- owned Neste Oy	7,385	11,361	61
KLM	38.2%	15,077	25,800	90
Luxair	23.11% + 13.41% state- owned bank	701	1,457	12
Olympic Airways	100%	6,403	6,596	43
Sabena	33.8%	8,749	11,995	38
SAS	50% (by three governments)	21,688	23,992	185
Swissair	20.7%*	12,891	25,800	73
TAP-Air Portugal	100%	4,538	8,300	31
(Air France)	(94.2%)	(33,169)	(55,747)	(227)
(BA)	(-)	(31,325)	(64,000)	(271)

\* - Confederation, cantons, municipalities and cantonal banks

Source: "World Airline Traffic Statistics 1998," "World Airline Fleets 1998," *Air Transport World*, July 1999, 77-82, 128-143.

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necessarily very limited, given short distances and the transfer times involved in air travel. But several small-country airlines (notably KLM) have always punched above their weight in international aviation. Further afield, Hong Kong and Singapore (which have respectively 39% and 22% the area of Luxembourg and have populations roughly equivalent to those of Denmark and Ireland) support two of the world's largest airlines. Smallness of territory and small population thus restrict the scope for domestic air services, but they do not necessarily prevent the creation of major international airlines.

Whether a small-country carrier can overcome the limits imposed by territory and population seems to depend on several factors, two of which are essentially economic. One is a domestic market sustained by passengers with high personal incomes (or generous travel budgets) and a strong propensity to fly: Dutch and Swiss carriers are helped by the importance of Amsterdam and Zurich as financial centers, while Belgian airlines have benefitted from the status of Brussels as the capital of the EU. Similarly, high personal incomes in Scandinavia help to explain the greater competition among airlines that has appeared on routes within the region, compared to routes in countries such as Greece and Portugal where personal incomes are lower.

The second economic factor is the appeal of the country concerned as a destination for foreign travelers. Such appeal may arise from economic growth and prominence. The success of Cathay Pacific and Singapore International Airlines is clearly related to the commercial affluence of Hong Kong and Singapore, respectively. Traffic may also be generated by tourism and by the existence of a large overseas diaspora: in selecting North American destinations, many of the carriers examined here have targeted major ethnic communities in such cities as Boston, Chicago, Seattle and Toronto.

Location is a third major factor shaping the ability of small country carriers to overcome the constraints of size. Arguably, location became more, not less, significant with the creation of the single European market. Strictly speaking, the latter is a misleading term since what the EC created in the late eighties was not a market but rather a single regulatory jurisdiction where there had previously been twelve jurisdictions. Within this new jurisdiction, firms could create, expand and compete for markets. But the SEM legislation also created a new center and a new periphery: this action had greater than jurisdictional significance since the center of the "market" was also where much of the EU's population and economic activity and resources were located.

Though many European observers were eager to compare the EU's approach to airline deregulation with that of the US, they usually missed the basic difference between the two areas in demography and distribution of economic activity - that as, an Aer Lingus official pointed out, "in the States, the people live on the edges and the hubs are in the middle. In Europe, the people live in the middle."<sup>5</sup> The hubs, too, were already in the middle - in national capitals - and the creation of the new single market jurisdiction was likely to compound the advantages of (though also to bring more competitive pressure on) those based in the middle of the deregulated area. The playing field might, as

EU officials like to claim, have become more level; but barriers that had previously restricted play were suddenly taken down, prospectively increasing the inequalities between those standing in its center and those standing at its edges.

But, for strategic purposes, location created a subtle combination of advantages and disadvantages. A central location brought obvious advantages to such airlines as KLM, Luxair, Sabena and - to some extent - Austrian Airlines. It brought them access to traffic in a densely-populated part of Europe and it offered them the possibility of creating (or expanding) hub-and-spoke systems for collecting and redistributing traffic from both neighboring and more peripheral points in the single market. But airports in the area were fairly close to each other and competition for traffic between them was increasing. Centrality also created threats: larger airlines such as Air France and BA were always interested in the possibility of establishing secondary hubs at the airports of smaller competitors such as KLM and Sabena. The latter also became the objects of courtship that was persistent and sometimes aggressive. Centrality thus presented both strategic opportunities and the risk of more intense competition and even takeovers.

Airlines on the periphery of the market faced a different combination of problems and opportunities. They had the comfort of expecting that larger carriers would ignore them because the markets they controlled were too small to be worth the cost and risk of entering them.<sup>6</sup> An official of TAP-Air Portugal saw other consolations in being peripheral: "We have to be realistic. Portugal is on the western point of Europe - we can't help that. It would be better if we were in the middle of Europe, but at least we have the sun!"<sup>7</sup>

Isolation from central markets and cities also gave a specific competitive advantage to air transport, especially when (as in the cases of Ireland and Scandinavia) a water crossing was involved. Moreover, as we shall see, airlines that were on the periphery of the European market sometimes had compensating geographical advantages in long-haul markets: Aer Lingus, for example, had an excellent location for tapping North American traffic, while Finnair had a distinct advantage for services to North East Asia because of Helsinki's location close to a "great circle" route between North America and Asia.<sup>8</sup>

But peripherality (combined with a small domestic market) was a serious obstacle to growth: as firms in a service industry, airlines could not simply move their bases to more promising markets. Absent growth in the economies of their home states or the discovery or creation of some special niche, airlines on the periphery could only grow by penetrating larger, more central markets, while trying to protect their control of their domestic markets. Penetrating larger markets (such as those in Germany or Britain) meant in practice either challenging larger carriers on their home ground or cooperating with them. Challenging an airline such as Lufthansa could provoke retaliation (which might take the form of buying or allying with a rival domestic carrier in the smaller state). In any case, the small country carrier would find that it no longer had (at least within Europe) the protection earlier provided by the international regulatory regime.

If we now classify European airlines (excluding those in former COMECON countries)

according to the size and location of their home countries, we can identify six categories:

- (1) Flag carriers based in the larger, more centrally-located Member States (Air France, British Airways (BA) and Lufthansa);
- (2) Flag carriers based in larger, more peripheral Member States (Alitalia and Iberia);
- (3) Flag carriers based in smaller, more centrally-located Member States (KLM, Luxair, and Sabena);
- (4) Flag carriers based in smaller, more peripheral Member States (Aer Lingus, Olympic Airways, and TAP-Air Portugal);
- (5) Flag carriers based in states, some of which were members of the EC while others were not (SAS);
- (6) Flag carriers based in European states not yet members of the EC (Austrian Airlines, Finnair and Swissair).

In the remainder of this paper, we shall concentrate mainly on the dilemmas and strategies of airlines in groups (3), (4), (5), plus Austrian Airlines and Finnair.<sup>9</sup> In order to understand their choices, however, it is essential first to describe the regulatory “box” within which they were made.

### **The Single European Market and international regulation:**

Between 1946 and the late eighties, international air traffic rights were subject to bilateral agreements between states (required under the 1944 Chicago Convention on International Civil Aviation) that authorized the signatory governments to assign such rights to national carriers. Fares, meanwhile, were largely coordinated through the traffic conferences of the International Air Transport Association (IATA). This regime led to almost universal protection of national flag carriers and (within Europe) to cartel-like “pooling” arrangements between airlines under which schedules were coordinated and revenue shared.

Small-country airlines enjoyed protection from the Chicago regime, but they (or at least the more ambitious among them) also suffered in the trading of rights to which it gave rise. Though the bilateral system protected small-country airlines from “invasion” by larger airlines, it also enabled larger countries (backed by their own carriers) to insist on application of a “balance-of-benefits” principle which required that the terms of a bilateral agreement should offer market access in rough proportion to the size of market in each country. Application of this principle naturally made it very difficult for airlines from smaller countries to secure the degree of access they wanted to potentially lucrative markets in the US and Asia. Moreover, when the US gave such access, it did so (at least latterly) as a tactical maneuver intended to put pressure on larger, neighboring countries to relax

protection of their markets. Further, even when the political rationale behind “open skies” agreements was obviously tactical, American airlines and labor unions still complained loudly and bitterly, arguing that it was unfair to open up their domestic markets to foreign competitors when the foreign markets concerned offered such limited traffic in return.

For the major European flag carriers, access to large foreign markets has always been crucial, because historically they have depended (much more than their American counterparts) on long-haul rather than domestic traffic (see Table 2).<sup>10</sup> In 1992/3, all the European flag carriers except Austrian Airlines and Luxair flew more than half of their mileage on long-haul routes and six flew over 30% of their international mileage on North Atlantic routes. More significantly, some of the small-country airlines were as dependent on long-haul traffic as their larger competitors. While seven of the small country airlines earned less than 66% of their Revenue-Passenger-Kilometers (RPKs) from long-haul flights, Swissair and KLM, respectively, earned nearly 77% and nearly 89% of their mileage from such flights.

Such overseas operations have been particularly important for countries with open economies heavily dependent on imports (and on exports to help pay for their imports).<sup>11</sup> Peripheral location increased the importance of an efficient airline. As an Irish government report pointed out, a country that had both an open economy and was distant from its main markets had a particular need for an efficient airline: it needed to export and its industries needed lower transport costs in order to be competitive. Therefore, having one or more efficient airlines was a priority: efficiency would enable the carriers concerned to lower freight and passenger rates.<sup>12</sup>

The problem was, however, where to find the traffic to support such carriers, given the small size of the domestic market and the reluctance of larger countries to give extensive traffic rights to the airlines of smaller countries. For the more enterprising small country airlines, the answer has often been to create hubs for transit (or “sixth freedom”) traffic.<sup>13</sup> As early as the nineteen-thirties, KLM, for example, had set out to draw passengers from neighboring countries to Amsterdam.<sup>14</sup>

The three EU liberalization packages helped airlines wanting to build such networks. They abolished Chicago-type bilaterals and the associated trading of rights within the jurisdiction of the European Union, allowing EU carriers (both large and small) to develop transit hubs without fear of regulatory retaliation by other European states. They also enabled airlines to go deep into the domestic markets of other carriers to add traffic to their networks.

But the liberalization of European air transport was only partial. It affected only services and carriers within the EU and it only opened up routes within the EU to EU “Community carriers.”<sup>15</sup> Moreover, routes to countries outside the EU remained subject to bilateral agreements under the Chicago regime, with all the restrictions and exclusivity entailed by such agreements. Thus when Air France flies from Paris to London, it faces (at least in principle) the prospect of competition from any other Community carrier that chooses to fly on this route. But when it flies between Paris and New York, it does so under the terms of the current France-US bilateral agreement which limits competition to French and US carriers. Even so-called “open skies” agreements are in fact only

liberalized bilaterals. While such agreements typically open up all routes between two countries to all carriers based in those countries (and remove restrictions on fares and capacity), they do not allow

TABLE 2: DEPENDENCE ON LONG-HAUL TRAFFIC, 1992\*

<u>Airline:</u> (ranked by total Revenue- Passenger-Kilometers (RPKs) 1993)	<u>Number of</u> <u>destinations outside</u> <u>Europe</u> (1996)	<u>% of total traffic</u> <u>from long-haul</u> <u>services (RPKs)</u> (1993)	<u>(% of all international</u> <u>traffic from North</u> <u>Atlantic)</u> (1992))
1. British Airways	89	84.2	(39.0)
2. Lufthansa	131	81.1	(38.2)
3. Air France	101	86.8	(25.5)
4. KLM	85	88.9	(39.8)
5. Alitalia	43	76.8	(32.1)
6. Iberia	34	76.6	(20.4)
7. Swissair	51	76.8	(NA)
8. SAS	10	63.5	(33.5)
9. Sabena	28	65.6	(34.7)
10. Finnair	9	61.4	(NA)
11. Olympic Airways	18	65.7	(24.6)
12. TAP-Air Portugal	21	62.9	(23.2)
13. Austrian Airlines	20	47.2	(NA)
14. Aer Lingus	3	55.8	(58.0)
15. Luxair	0	-	-

\* - based on Revenue-Passenger-Kilometers (RPKs).

Sources: Figures drawn from Association of European Airlines, 1996, 67; Commission of the European Communities, 1994, 55 (Table E).

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airlines from other countries to fly on these routes.

The European Commission has consistently argued that bilateral agreements between Member States and “third countries” (such as the US or India) are inconsistent with the single market because their exclusive nationality clauses prevents the airlines of all Member States from operating at will between airports in the EU and airports in third countries. At present, BA (for example) may not fly between Paris and Washington because such flights are reserved for French and US airlines under the France-US bilateral.<sup>16</sup> The Commission has therefore conducted a long legal campaign to take over the negotiation of traffic rights with “third countries” from Member States (a right that it also claims as an expression of its jurisdiction over external trade agreements). It has also taken action in the European Court of Justice against Member States who have reached “open skies” bilaterals with the US. In November 2002, the ECJ supported the Commission at least to the extent of ruling that such agreements were incompatible with Community legislation because of their exclusion of airlines from Member States other than those that are signatories to the agreements.

Though most EU Member States have now concluded open skies agreements with the US, it was the smaller states that took the lead in negotiating them. “Open skies” agreements offered them the prospect of by-passing the “balance of benefits” principle and obtaining far greater access to the US market, without any great risk of an “invasion” of their home markets (small as they were) by American mega-carriers. In fact, open skies agreements were frequently accompanied by the conclusion of alliances between the Member State flag carrier concerned and a US carrier. Such alliances made it possible for both airlines to penetrate domestic markets abroad. Since (under the principle of cabotage) a European carrier was prohibited from flying on routes within the US (with an American carrier facing a similar prohibition within the European single market), the next-best strategy was to create alliances that would enable a European carrier to draw from traffic into and out of its American partner’s domestic hubs, while the American partner drew on traffic into and out of its European partner’s hub.

Such operations could be highly profitable since they offered opportunities for economies of scope (“synergy savings”) due to coordinated marketing and operations and more efficient use of resources. But to reap their full benefit (for the airlines, if not for their customers), alliances required the protection of a waiver of US anti-trust law, which would normally restrict close coordination of fares and schedules.<sup>17</sup> So the US government, eager to propagate open skies agreements, shrewdly made signature of such agreements a condition for providing anti-trust immunity for transatlantic alliances.

For small-country airlines (among others), the persistence of bilateral agreements with “third countries” constitutes a regulatory obstacle to being taken over and to losing valuable long-haul

traffic to rivals. State ownership has historically created a primary obstacle to mergers and acquisitions since there was little or no public trading of airline shares. Privatization has, however, reduced the power of such protection, though many governments have inserted “golden shares” and other legal provisions to protect airline nationality (required by the Chicago system).

Exclusive nationality rules discourage mergers and acquisitions, even when shares are traded, and would do so even if governments did not intervene to restrict trading. If, for example, Air France bought a majority of the shares of TAP-Air Portugal, non-European airlines and governments might well challenge TAP’s credentials as a Portuguese airline (that is, one “substantially owned and effectively controlled” by Portuguese nationals) and might question its right to continue flying on routes between Portugal and American and other destinations outside the EU covered by bilateral agreements.<sup>18</sup> Investment across borders, however legal, is therefore pointless if it results in loss of international traffic rights. Corporate alliances are, again, the next-best solution, because they offer opportunities for control and coordination without challenging airline nationality.

The survival of small-country airlines is not, however, just due to the protection inadvertently provided by persistence of the Chicago regulatory regime. Protection against takeover does not guarantee solvency or provide a defense against the competition that all Community carriers have to face on routes within the EU. Moreover, the advent of global alliances puts special pressure on small-country airlines to show themselves to be efficient and profitable (and therefore worthy of being admitted to an alliance), to compensate for the small markets they can offer to prospective alliance partners. Such pressure has become all the greater as more airlines enter alliances and as the alliances themselves become increasingly exclusive (by, for example, refusing ground services to airlines that are not alliance partners).

Explaining the survival of small-country airlines therefore requires examining the constraints and opportunities that have shaped their choice of strategies. The remainder of this paper explores the environment in which small-country airlines have had to make choices and the range of strategies that their managements have considered and adopted. It also asks how far the current situation of such airlines represents success in terms of preserving both their independence and their prospects for growth.

### **Facing the Single Market:**

In the late eighties, the managements of small-country airlines were well aware of the threats and opportunities presented by the single market. They frequently heard predictions that the European industry would become consolidated into two or three “mega-carriers” (not least because one of their own CEOs - Jan Carlzon of SAS - was a leading exponent of this view). They were also aware of the plans of larger carriers to expand their operations so as to seize market share before competition became fully effective in 1997.

But airline officials differed about how to respond to the single market. Some, such as Carlzon

and his colleagues at SAS, doubted that their airlines could survive by adopting a “stand-alone” and defensive strategy.<sup>19</sup> “If we sit in Scandinavia,” Carlzon said, “we will have too small a market to be competitive.”<sup>20</sup> SAS therefore launched a dramatic program of investment in foreign airlines (and new aircraft) with the goal of creating “a global traffic system.”<sup>21</sup> Within Europe, SAS wanted either a merger with an airline that controlled a major market or an alliance of smaller carriers that would be big enough to match the majors. SAS quickly became the earliest example of a small-country carrier adopting a “global alliance” strategy.

Others believed that small-country airlines did have an independent future. For example, in 1988, David Kennedy, the chairman of Aer Lingus, told a seminar that “he did not accept that the eclipse of small carriers, like Aer Lingus, was inevitable with the relaxation of European airline regulation.”<sup>22</sup> Kennedy continued:

My thesis is that there is life after liberalization for the smaller European carrier, and a fuller life than merely acting as a vassal of one of the major carriers operating feeder services into a megahub.<sup>23</sup>

Though SAS and Aer Lingus differed about the prospects for small-country airlines, both airlines decided to adopt an expansive policy. Other airlines (notably Finnair) preferred a “stand-alone” policy. While anxious to obtain access to the single market, Finnair’s philosophy was consistently and firmly independent.<sup>24</sup> Antti Potila, its president, declared that small airlines could survive if they were realistic and prudent. Potila reportedly believed that Finnair could “survive as an independent and profitable operator,” if it accepted “the limitations placed by geography and the strengths of competitors” and adapted its product to its market while watching its costs carefully.<sup>25</sup> Airlines on the periphery of the single market, Potila argued, had to accept the role of a “niche” carrier. “We do not try and do not want to be one of the global airlines [Potila concluded]. The question is, what is a niche and what is our niche.”<sup>26</sup>

The Portuguese were also sensitive to the issue of independence and possible threats to it from larger carriers. TAP-Air Portugal was (as a report by Lehmann Brothers noted in 1993) an airline that had always been “particularly anxious to maintain its independence and identity”:

The TAP philosophy has always differed from that of other smaller European carriers in the sense that it believed smaller airlines would still be able to compete effectively with the major carriers on specific routes.<sup>27</sup>

For some airlines, exclusion rather than loss of independence was the immediate problem. Along with Finnair, Austrian Airlines and Swissair faced the special uncertainty of not knowing whether they would be able to participate in the single market since their home countries had not yet joined the EC. The managements of Austrian and Swissair earnestly hoped that their countries would join the Community. But between July 1989 and 1994 Austria was at least under consideration as a member of the EU and with its admission in January 1995, its flag carrier got full access to the single market. Swissair, on the other hand, was confronted in December 1992 by the Swiss voters’ rejection

of membership of the European Economic Area (EEA). Thereafter Swissair made strenuous efforts to enter the single market through proxies such as Sabena and TAP-Air Portugal, but it only acquired rights commensurate with Community carriers in 1999.

### **Strategies:**

While airline managements differed about the prospects for their carriers, their strategies for coming to terms with the single market had (as Doganis points out) some common elements. Most pursued three goals, namely: (1) to secure their domestic markets against domestic rivals (actual or potential) and outside interlopers; (2) to create alliances with other carriers (either flag or regional carriers) in EU states in order to increase the flow of passengers through national hubs; and (3) to explore global alliances.<sup>28</sup>

In practice, small-country airlines approached these goals (and others) through a range of strategies, which can be identified as follows:

- (1) A transatlantic and/or global alliance strategy, giving priority to long-haul routes and penetrating major markets outside the EU;
- (2) A European niche strategy, in which a carrier concentrates on becoming the dominant airline serving the country in which it is based and exploiting the specific locational and economic assets of that market;
- (3) A long-haul niche strategy in which a carrier concentrates on exploiting long-haul routes on which it enjoys a comparative advantage because of location and/or cultural and historical affiliations;
- (4) A defensive alliance with other small-country airlines intended to hold at bay larger carriers within the European market and - through cooperation in such activities as scheduling, marketing, purchasing and maintenance - to secure economies of scale otherwise denied to them by virtue of their small size;
- (5) An alliance with a larger European carrier in which the small-country airline protects its regional market while becoming a feeder for the larger airline;
- (6) An alliance with several carriers, large and small, intended to obtain the benefits of cooperation while protecting the commercial and institutional independence of the airline adopting the strategy;
- (7) A service niche strategy in which an airline aims to attract certain types of customers (usually business passengers) by offering accommodation or flights appropriate to their preferences and needs; and

(8) A diversification (or “aviation business”) strategy in which a carrier reduces its direct exposure to the risks of the air transport industry by investing in a range of related businesses, such as hotels and resorts, restaurants, aircraft maintenance and repair, airline catering, ground handling of passengers and freight, and informatics and data processing.<sup>29</sup>

Some of these strategies may be (and have been) pursued simultaneously (for example, the global alliance strategy and the service niche strategy). Some were adopted by specific airlines and then (as we shall see) abandoned in favor of others.

We now examine a selection of these strategies in order to assess the value of each as a “survival” strategy for small-country carriers.

### **(1) The global alliance strategy: SAS and KLM**

By 2000, all EU flag carriers (except for Olympic Airways, Luxair and TAP) had joined some form of international alliance.<sup>30</sup> But we should distinguish between those that took the lead in establishing alliances, mainly as an initial response to the creation of the single market, and those that joined an existing alliance in the mid- or late-nineties, in an effort to avoid isolation.

SAS under Jan Carlzon was the most dramatic example of an airline that decided early to break out of the limitations imposed by the size and location of its home market. To meet “the threat of being relegated to a regional carrier,” SAS undertook a bold program of investments and alliances within and outside Europe, becoming involved in non-core businesses (including hotels) as well as other airlines. Closer to home, Carlzon’s aim was to create a “‘Pan-European’ system” (a goal that he pursued through a strategy of allying with other smaller airlines [see below]).

In expanding abroad, Carlzon was building on SAS’s well-established reputation as an innovating, internationally-minded carrier. But by 1981, when Carlzon took over, SAS was in eclipse. It had lost market share and its reputation for service and punctuality was tarnished. Between 1981 and 1987, Carlzon therefore worked to transform the airline, especially by concentrating on business passengers. By 1986, SAS was the second most profitable passenger-carrying airline in the world.<sup>31</sup>

Carlzon’s success gave SAS substantial reserves, which he used for investments abroad. By 1990, SAS had invested \$721 million in airlines, hotels, catering and other subsidiaries, as well as \$300 million in the Amadeus computer reservation system.<sup>32</sup> Within Europe, Carlzon was intent on checking the expansion of the newly-privatized BA and tried to buy BA’s main domestic rival, British Caledonian. When this bid collapsed, he acquired a 24.9% (later, 40%) stake in the Airlines of Britain group, which controlled (principally) British Midland Airways, an airline with significant slots at Heathrow. Carlzon also tried to create an alliance with Sabena (to lead eventually to a virtual merger): this (and the British Midland deal) would give SAS a hub in the center of the single market.<sup>33</sup>

SAS's investments outside Europe were equally bold (though, to some observers, puzzling). The most important was a two-stage investment of \$106 million in the US carrier Continental Airlines which was close to (and eventually filed for) bankruptcy. In Latin America, SAS invested \$35 million in LAN-Chile, another airline with serious financial problems. Within Asia, it strengthened an existing alliance with Thai International and reached a marketing agreement with the Japanese airline ANA. Finally (but not least), SAS bought a 40% stake in Saison Holdings, the owner of the Inter-Continental Hotels chain.

Carlzon had thus successfully adopted a "service niche" strategy and had taken the initiative to "break out of isolation." But his approach did entail risks and did forego the benefits of other solutions. Though he succeeded in cutting administrative costs, Carlzon's approach emphasized investment, revenue generation and efficiency rather than austerity.<sup>34</sup> It implicitly accepted SAS's high labor costs, which were typical of Scandinavian firms. Heavy investment made the airline's balance sheet dependent on consistently high fares and high revenue: given Carlzon's emphasis on the business traveler, SAS was therefore exceptionally vulnerable to economic recessions.

Thus when a recession occurred in the early nineties (aggravated by the Gulf War), SAS was especially hard hit.<sup>35</sup> The airline's board decided to divest heavily, ending its Continental and Chilean investments and selling its stake in Inter-Continental Hotels, along with other economies.<sup>36</sup> Under a new CEO, SAS moved to a "Nordic niche" strategy, concentrating on dominating the Scandinavian market while giving up some long-range routes and aircraft.<sup>37</sup> Subsequently, SAS began searching for an ally that would "complement and strengthen its Nordic-oriented route network."<sup>38</sup> In effect, the switch from a global to a regional niche strategy led to an equally sharp change in alliance strategy. In 1995, SAS became an admitted "junior partner" of a large-country carrier, Lufthansa, within a new global alliance, the Star Alliance.

KLM, like SAS, had always seen itself as an intercontinental carrier. But its efforts to build up a long-haul network went back further than its Scandinavian rival and had brought it destinations in every continent.<sup>39</sup> Moreover, while SAS had a significant (and well-protected) domestic market on the periphery of Europe, KLM had a small and centrally-located domestic market: it was also vulnerable to competition from the airlines of large neighboring countries. Though both SAS and KLM were significant money-earners for their home countries, KLM had long since established itself as (in the words of *The Economist*) "one of the world's few true merchant airlines, [one] which had grown by bidding for traffic wherever it could find it."<sup>40</sup> The Dutch government supported it actively in this quest: recognizing the contribution that KLM's foreign earnings made to the Dutch economy, it regularly provided both diplomatic assistance and capital to its flag carrier.

Though KLM had been consistently profitable since 1976, its management knew that with the creation of the single market the airline would have to face increased competition within Europe (where its market share was relatively small).<sup>41</sup> It therefore decided both to intensify its expansion abroad and to try to increase its market share within Europe: this strategy was feasible since KLM (like SAS) had, by 1988, accumulated considerable reserves that could be used for new equipment and investments. Some of the new aircraft would be used to build up KLM's European network:

expanding this network was crucial both for feeding its long-haul routes and for making itself attractive to prospective transatlantic partners. To ensure “feed” into Amsterdam, KLM therefore acquired or increased holdings in foreign-based regional carriers such as Air UK (later KLM UK) and Eurowings of Germany.

Beyond Europe, KLM committed itself to a global alliance strategy that was in line with its long-established inclination to be an “intercontinental” rather than a “European” airline. Its main (and long-standing) objective was to obtain greater access to the US market. Such access had been difficult to achieve because of the small size of the Dutch market and was essential for KLM’s overall strategy and its finances. Fortunately, the Dutch regulatory philosophy was as liberal as that of the US, and KLM was eager for an open skies agreement with the US. Having signed a liberalized bilateral with the US under the Carter administration and having advocated liberalization within Europe, the Netherlands opposed the protectionism that several of its larger neighbors practiced when the larger American carriers began to expand their services to Europe in the late eighties.<sup>42</sup>

The ground was thus laid in Washington and the Hague for cooperation between KLM and an American carrier. The occasion for such cooperation came in 1989, when KLM found itself, fortuitously, with an opportunity to buy equity in and form a commercial alliance with Northwest Airlines (like Continental, an airline in serious financial trouble). Seeing the advantages of linking its flights to the Northwest hubs in Detroit, Minneapolis and Memphis, KLM decided (after only two hours of discussion in the Board of Supervisors) to invest 577 million guilders (\$400 million) in Wings Holdings (the holding company for Northwest), acquiring thereby 20% (later, 23%) of the common stock of Wings, as well as acquiring \$300 million’s worth of preferred stock. Both airlines then began to develop forms of coordination in marketing and operations that were reinforced with the conclusion in 1992 of an open skies agreement between the Netherlands and the US and the granting of anti-trust immunity to the alliance. Despite serious boardroom conflicts, the KLM-Northwest alliance proved highly profitable for both carriers and was a model for the kind of extensive integration and code-sharing later introduced by other alliances.

But KLM’s initiative also revealed some of the problems of pursuing a global or transatlantic strategy in the context of the European single market. One problem (first exposed by the 1992 Dutch bilateral) was the opposition of the European Commission to the signing of new bilaterals that gave exclusive privileges to one Member State and its airlines rather than to all Community carriers. Another, more strategic in character, was the tension between the imperatives of securing alliances outside Europe and the wish to cooperate more closely with other European carriers. Since alliances were, virtually by definition, exclusive, conflicts of loyalty occurred for airlines who wanted both to have a special relationship with an American carrier and to work more closely with European airlines, most of which had their own transatlantic relationships.

## **(2) European niche strategies: Luxair, Aer Lingus, and Finnair**

Even those European airlines that gave priority to long-haul routes had to pay attention to

their services within the single market. For airlines with smaller stakes in long-haul routes (and less ambition to acquire them), an obvious strategy was to consolidate control of their home markets and then to take advantage of the single market to develop new routes within Europe.

But this strategy could be (and was) pursued with very different degrees of ambition. Some airlines (such as Luxair and Finnair) were cautious and deliberate in expanding their networks, while others (notably Aer Lingus) applied to the European market the same expansive and pre-emptive approach that SAS (and, to a lesser extent, KLM) applied to the long-haul market.

Luxair, the national carrier of Luxembourg, was an exemplar of discreet niche strategizing. It was one of the younger EU carriers, having only been established in 1961, mainly in response to the establishment of financial and other service industries and the installation of EC institutions in Luxembourg which created (in the words of the airline's own history) "[a] real need for efficient air connections between Luxembourg and other European capitals."<sup>43</sup> Serving a country with a population of only 400,000 and with a staff of only 1,450, Luxair adopted - and maintained - a consistent regional niche strategy, operating flights within Europe exclusively to and from Luxembourg until 1999.<sup>44</sup> Though Lufthansa took a 13% share in Luxair, the latter was not an object of any takeover bid nor did it become involved in the alliance game.

Finnair was a more complex case. Unlike Luxair, it was located on the periphery of the European market (and, indeed, was not formally admitted as a Community carrier until 1994). But Finland (unlike Luxembourg) was large enough to support domestic air services, even with a population of only 5 million. Moreover, Finnair had experience (and a good reputation) as a long-haul carrier and was anxious to develop both a niche within Europe and a more extensive long-haul network. The question, as Antti Potila had put it, was what niche it should try to occupy.<sup>45</sup>

Rejecting the kind of aggressive expansion and alliance-building favored by Carlon, the Finnair management adopted a strategy characterized by rugged independence and a dogged emphasis on building very specific regional and service niches. The airline's policy was, indeed, consistently one of protecting Finnair's independence by avoiding close alliances with other carriers. Its independent-mindedness was clearly shown by its behavior as a member of one group, a small-airline coalition (labeled the European Quality Alliance [EQA]) formed by SAS, Swissair, Finnair [briefly] and Austrian in 1990). After only a year as a member of the EQA, Finnair withdrew from the alliance in September 1991, following a meeting in Vienna at which SAS and Swissair had pressed for much closer integration in scheduling and marketing between the members and, reportedly, had asked the Finns to give up all flights between Copenhagen and Helsinki.<sup>46</sup>

With such an independent stance, Finnair had to work hard to establish market share in northern Europe, setting up a hub in Helsinki. It benefitted from the end of the Cold War to expand its services to the Baltic republics and the CIS.<sup>47</sup> As soon as it was admitted to the single market, Finnair also set up a secondary hub in Stockholm to challenge SAS and created ties with several independent Scandinavian carriers.

Finnair's strategy of creating a "gateway" in Helsinki (along with a secondary hub in



Stockholm) had both strengths and weaknesses. Such a strategy was appealing since it enabled an airline to bypass the limitations of its home market and (if the “niches” were chosen carefully) could enable it to grow without becoming involved in entangling and sometimes restrictive alliances. But a strategy involving reliance on transit traffic was essentially brittle.<sup>48</sup> It entailed greater dependence than a simple hub-and-spoke system on economic conditions in the particular foreign countries targeted by the niche strategy: the risks of depending on prosperity in the successor states to the Soviet Union were all too clear.<sup>49</sup> Moreover, as KLM knew all too well, “sixth freedom” operations inspired resentment and invited retaliation from airlines in the targeted countries which saw traffic drained from their own services and their own hubs..

A different and more expansive form of niche strategy was adopted in the late eighties by another peripheral carrier, Aer Lingus. Much of Aer Lingus’s business came from the North American services that carried tourists and immigrants and their friends and relatives between Ireland and the US. But the airline’s management was (as we have noted) confident of the airline’s ability to survive the single market.<sup>50</sup> It therefore focused for several years on ways of taking advantage of the imminent liberalization within Europe rather than on developing its money-losing transatlantic operations.

An aggressive strategy in Europe was linked to the issue of joining an alliance. By adopting an aggressive strategy, Aer Lingus would make itself attractive to potential alliance partners, its management being convinced that (in the words of its CEO) “an airline has to get into a relationship these days ... you need to have that long-term relationship or you’ll find yourself restricted to point-to-point traffic.” By expanding outside Ireland, Aer Lingus would become “a Community airline, not an Irish airline.”<sup>51</sup>

Aer Lingus created a connecting hub in Manchester from which it started services to Amsterdam, Copenhagen, Hamburg, Milan, Paris and Zurich, in direct competition with BA. Technically, these services were based on the “fifth freedom” rights provided by the third liberalization package: such rights enabled EU airlines to fly between Member States other than their own provided that the flights in question originated and ended in their home state (thus a Manchester to Amsterdam flight was technically a continuation of a flight from Dublin to Manchester). Aer Lingus also talked about investing in British and continental airlines and became involved in charter airlines in Spain and Turkey.<sup>52</sup> The airline’s management even considered entering the long-haul market between Europe and Japan and Australia in alliance with an Asian or another European airline.<sup>53</sup>

But the European strategy did not work. The fifth freedom routes from Manchester proved unprofitable, demonstrating the great difficulty of challenging established national carriers in their own markets.<sup>54</sup> As the Group Chief Executive, Gary McGann, later put it:

The evidence in Europe is that anyone doing business in someone else’s power base on an equal service, unless they have very deep pockets, the incumbents [sic] will take them out on price.<sup>55</sup>

The lesson, according to McGann, was to reinforce Aer Lingus's position on routes to Ireland - in his words, "to build our presence on existing routes, growing frequencies and networks to defend against the opposite happening - someone coming onto our routes."<sup>56</sup> In the future, Aer Lingus would only expand its European services with "extreme caution" - not within the next two-to-three years and later only in cooperation with a partner. As a result of a brush with bankruptcy in 1993, it backed away from aggressive expansion toward a carefully-defined niche strategy - conveyed by McGann's comment that Aer Lingus had acquired "some sense of where we fit into the scheme of things".<sup>57</sup> This niche included a return to the North Atlantic routes where it enjoyed a clear comparative advantage, especially once the government had relaxed its rule requiring a stop at Shannon on all transatlantic flights.<sup>58</sup>

### **(3) Long-haul niche strategies: TAP Air Portugal, Sabena and Finnair:**

Because of their home countries' colonial history, several EU carriers had acquired experience (and therefore substantial market share) on long-haul routes to Africa, Asia and Latin America. Air France had strong connections to parts of Africa and the Middle East, while BA had inherited links to Britain's former African colonies, south Asia, and various other Commonwealth countries. KLM had built up its network around flights to the Dutch East Indies. Decolonization had seriously disrupted the operations and finances of all these airlines, requiring them to switch capacity to other areas (typically, Europe and the North Atlantic).<sup>59</sup>

Two small-country airlines - TAP Air Portugal and Sabena - had similar connections and problems. Before 1987, TAP was an airline that concentrated on (and had been built around) Portugal's residual colonial empire - its African colonies and Macau.<sup>60</sup> After the revolution of 1974, the new socialist government nationalized TAP and withdrew from the African colonies. Since some 45% of TAP's traffic and 60% of its revenue had come from colonial services, decolonization created a major financial crisis for the airline.<sup>61</sup>

Though TAP subsequently concentrated on expanding its European and North Atlantic services to compensate for loss of colonial traffic, it kept open a number of services to sub-Saharan Africa and was required by the government to operate unprofitable services to Macau. TAP also exploited its older imperial and cultural connections to Brazil: by the mid-nineties, it was flying to four destinations in Brazil, plus Caracas and Curaçao. Strategically, both the African and Latin American connections gave TAP a claim on the attention of potential alliance partners since it could offer a convenient hub for passengers flying to Brazil and to such countries as Angola and Mozambique.

Sabena's colonial history was unusual. Sabena (and Belgium) had only one major territory - the Belgian Congo - to deal with. Moreover, Sabena had been started as a company that would provide air services in the Congo: though it also offered services within Europe, its routes to Leopoldville and other cities in the Congo were central to its operations and its finances.<sup>62</sup> Even after

independence, Sabena continued to be heavily involved with the former colony. One effect of Sabena's exceptionally close relationship with the Congo was that it had a very thin long-haul network to North America and other continents. Another was that its finances and strategy continued to be weighed down by the expectation of successive Belgian governments that Sabena should be an instrument of Belgian diplomacy in its complicated and frequently tortured relations with President Mobutu and his predecessors. Despite many problems, Sabena continued to treat the Congo/Zaire route as a major niche and to accept its role as a political intermediary.<sup>63</sup>

A very different case of a long-haul geographical niche (without any colonial background) arose from Finland's location close to a "great circle" route between north America and north-east Asia. Such a location gave Finnair a significant advantage for flights between both Europe and North America and Japan and Korea. At one time, it was in fact the only European airline flying non-stop from Europe to Japan. In the nineties, the Russian government's decision to allow direct flights across Siberia enabled flight times on services to Japan to be cut by over three hours and Finnair built up routes to east and south-east Asia, using Helsinki as a connecting hub to other European destinations and even to North America.<sup>64</sup> By 2002, Finnair had only five long-haul routes (apart from those operated on a code-sharing basis with alliance partners): four of them were to Asian destinations and these services were typically full and very profitable.<sup>65</sup>

#### **(4) Small-airline alliances:**

From the late fifties, several small-country airlines had been intermittently attracted to the idea of pooling their resources. Initially, this idea took the form of cost-saving arrangements covering repair and maintenance (as in the so-called KSSU agreement between KLM, SAS, Swissair and the French independent UTA).<sup>66</sup> But with the advent of the single market, it acquired broader meaning as a strategy of self-defense against the supposedly aggressive intent of large carriers such as Air France, BA and Lufthansa.

In fact, as noted above, cooperation between European airlines had a long history, mainly through cartel-like arrangements for coordinating schedules and sharing revenue. Several proposals had also appeared over the years for a "pan-European" airline, culminating in the Air Union project of the early sixties.<sup>67</sup> Though the latter project finally collapsed in 1967, the small-country airlines continued to seek ways of cooperating.<sup>68</sup>

Within the larger European market, the main platform for a small-airline alliance was the European Quality Alliance. This alliance was a vehicle both for Carlzon's vision of a "Pan-European" airline and for Swissair's hopes of avoiding isolation from the single market. It was intended to achieve substantial increases in efficiency for the partners through the sharing of costs; but Carlzon wanted it to go much further, toward a virtual merger (hence Finnair's withdrawal). But in reality (with only loose coordination) the savings gleaned by the EQA were modest and, though the alliance carried substantial traffic within Europe, it controlled only 10.7% of the long-haul traffic of European airlines in 1991.<sup>69</sup>

So early in 1993 Carlzon and the Swiss decided to attempt a more ambitious project which (under the label of “the Alcazar alliance”) would involve KLM as well as the three remaining EQA partners in the creation of a “fourth force” airline.<sup>70</sup> With combined traffic of some 32 million passengers a year, the Alcazar alliance would have roughly 270 aircraft and 87,000 staff and would control 20% of the European market.<sup>71</sup> Carlzon’s vision was to create something that no national carrier had yet developed - an airline with a multi-hub European network. Before 1993, this network was to have hubs in Copenhagen, London (Heathrow), Vienna and Zurich (the main bases of the four EQA members and British Midland): in the Alcazar scheme, Amsterdam would be added and Heathrow dropped.

Negotiations over Alcazar therefore focused on the creation of a single holding company in which KLM, SAS and Swissair would each have a 30% holding, with Austrian (much the smallest of the four) holding the remaining 10%. Within the framework of this company, a single airline would be created by 1997, under a joint management group to be established in 1994. Though the negotiations were intrinsically complex, considerable progress was made in solving the problems of cooperation and integration within Europe. The breaking point was the issue of a US partner.

In 1989, Swissair had established a loose marketing alliance with Delta Airlines and Singapore International Airlines, which was cemented with a symbolic exchange of equity. When the Alcazar talks began, the Swiss negotiators (according to the president of Swissair) made it clear to the other airlines that Swissair’s commitment to Delta was non-negotiable: they claimed subsequently that KLM seemed open at this point to abandoning its alliance with Northwest.<sup>72</sup> But by the autumn of 1993, KLM had decided to insist that Northwest should be the transatlantic partner for the new airline and the Alcazar talks eventually collapsed over this issue. Even an official of KLM admitted that his airline’s insistence that the Alcazar group choose Northwest as its American partner “was the real and only reason for the failure [of the talks].”<sup>73</sup>

The collapse of the Alcazar project exposed basic differences in the stakes and philosophies of the small-country carriers and illuminated the strategic dilemmas they faced. Though some critics of KLM blamed the collapse on “Dutch intransigence,” the deeper problem was a tension between, on the one hand, the wish of small-country airlines to defend their domestic markets against their larger competitors and, on the other, the equally insistent imperative of getting access to large markets outside the EU. As a perceptive (but unidentified) participant in the talks observed:

KLM’s focus was primarily on the intercontinental market and its international partnership, while the other three were interested in building a strong home market together first, as a prelude to an increased market presence.<sup>74</sup>

In principle, it might have been possible to combine a small-country alliance with an alliance with a major US carrier. But the Alcazar episode showed, for the first time, that the value of a transatlantic alliance could trump the potential value of a European alliance: as an official of one of the airlines remarked bitterly, “We all said goodbye to \$1.3 billion worth of European synergy for the sake of \$50

million in synergy with the US.”<sup>75</sup>

In fact, they also said goodbye to the concept of a small-country alliance as a feasible or at least exclusive strategy for coping with the pressures of the single market. Carzon left the airline industry, disappointed by the failure of the Alcazar negotiations. After 1993, all four parties to the Alcazar project adopted strategies that involved a relationship with an American carrier, sometimes in partnership with a large European carrier.

Swissair did, however, try to create an alliance (built upon the EQA) with several of the smaller carriers within the EU, notably Sabena and TAP, with Delta as its American partner. But Swissair proceeded by purchasing equity rather than by creating a consortium. Indeed, the attraction of an alliance with Swissair for both the Belgians and the Portuguese was precisely that it might bring the capital that both airlines desperately needed and that their governments were unwilling to provide.

In the case of Sabena, Swissair’s purchase of a 49.5% holding in 1995 was intended to provide a base within the single market to compensate for Swissair’s legal exclusion as a Community carrier.<sup>76</sup> Sabena became one of ten or eleven companies in the Swissair-led Qualiflyer Group and, under a Swiss president, undertook a major expansion with 25 new aircraft on order.<sup>77</sup> By 1998, Sabena was actually making a profit and had substantially expanded both its network and its traffic. Critics claimed that Swissair had quietly engaged in asset-stripping, transferring the more profitable routes to itself and scheduling services so as to divert passengers to Zurich.<sup>78</sup> But from the Belgian government’s point of view, the sale of equity brought a welcome end to a long search for a partner that would provide capital, and it was eager to part with more.

The Portuguese government, for its part, was also anxious to find an investing partner for TAP. During the early nineties, TAP had gone through a major crisis, but with the aid of a large capital injection (approved by the European Commission) it was back in the black by 1997. Characteristically, TAP’s management was reluctant to become involved with a large carrier. As one official remarked:

Airlines such as British Airways or Lufthansa are very good companies, but they are too big for us. Our aim is to keep the Portuguese nature of TAP. It is more difficult to keep the identity of a small airline if you join an alliance with a big carrier.<sup>79</sup>

TAP therefore decided to join the EQA (which survived the demise of Alcazar) precisely because it was not under “the total domination” of one airline. In December 1997, the SAir Group announced its intention of buying 10% (later, 20%) of TAP’s stock if and when the Portuguese government proceeded with its plan for privatizing the airline. But this deal eventually collapsed partly because of objections by the European Commission on grounds of reduced competition on the Lisbon-Brussels route.

Shortly afterwards, the collapse of Swissair also brought the end of Swissair’s relationship

with Sabena, and Sabena itself went into bankruptcy. Though Sabena's management (like that of TAP) had preferred to ally with a smaller carrier, this approach made the Belgian carrier a hostage to the ambitions of another carrier of limited resources and therefore a victim of the other airline's over-extension. Over a longer period, Sabena's autonomy had atrophied, the foreign partner's role increasing with each new proposal for cooperation.<sup>80</sup> Though its collapse in 2001 was dramatic, as a truly independent company Sabena had in fact been disappearing, Cheshire-cat-like, for the previous fifteen years or so.

TAP's case also revealed the restricted choices open to a smaller airline that had exhausted the willingness of its government to provide more money and that had relatively little to offer a major partner. It survived but (like Olympic of Greece) has not yet become a member of an alliance. As we shall see in the concluding section, a subtler diminution of autonomy has happened to other small-country airlines.

#### **(5) Alliances with larger airlines:**

From 1987 on, the main object of most small-country flag carriers was to protect their independence (and their markets) from the expected depredations of their larger rivals. As we have seen, they used a variety of stratagems to ensure their survival and autonomy. But, whatever strategy they used, many have in fact ended up as junior partners to the larger airlines, their subordination being somewhat disguised by the rhetoric of global alliances. In short, though mega-carriers have not emerged in the way anticipated in the eighties (through bankruptcy and consolidation), the establishment of alliances (and the pressures they create) has in effect eroded the independence to which smaller carriers were so attached. Without losing their formal identity, they have become incorporated into networks that tend to reflect the distribution of market power within the industry.

Such "network incorporation" can be seen in the cases of Finnair, SAS, and Aer Lingus. Both Finnair and SAS were anxious to have greater access to the German market. The Finns said that Finnair needed "a strong central European partner" and between 1991 and 1995 it established a loose marketing alliance with Lufthansa.<sup>81</sup> But in 1995, Lufthansa brought SAS into what became the Star Alliance (with United as the American partner) and, in October 1997, told Finnair that it wanted to end its marketing relationship.<sup>82</sup> SAS, for its part, had considered the possibility of allying with a smaller carrier but had rejected this choice because of the value of the German market. As an SAS official put it, "...we needed to link up with a partner that had a sizable home market. We saw that airlines like KLM and Swissair had very limited home markets and would be very dependent on us trying to channel traffic through their hubs."<sup>83</sup>

In both cases, observers commented that in the prospective alliance Lufthansa would be the dominant partner.<sup>84</sup> SAS officials argued that a junior status was acceptable since it assured the airline of "a strong partner" without losing its independence.<sup>85</sup> Certainly, SAS's membership of the Lufthansa-United alliance represented a complete reversal of Carlzon's grand design and some of the ties he had created.<sup>86</sup> Its management settled, instead, for a more modest, regional niche strategy,

though (like Aer Lingus) its niche included a long-haul element (for SAS, like Finnair, the routes to northeast Asia) made possible by location. The new strategy, in the words of its President and CEO, enabled SAS “[to] operate in a global market without having a global presence.”<sup>87</sup> Carlzon’s strategy had, to the contrary, insisted that only by having a global presence could SAS even survive, let alone be a major international carrier.

For Finnair, the question was whether to seek another partner (partly to defend itself against the Lufthansa-SAS alliance). In December 1998, it announced that it would be joining the Oneworld alliance, led by BA and American. Within this alliance, Finnair (while continuing to stress its independence) would serve as a counter-balance to the Star Alliance as a member of a “Nordic” network that BA had been developing.

By the mid-nineties, Aer Lingus had (as noted above) already accepted a changed (and diminished) sense of where it fitted into “the scheme of things.” Aer Lingus, said the airline’s annual report for 1996, could not “escape the fact that in international terms, [it was] a small and potentially vulnerable player in an increasingly concentrated global industry.”<sup>88</sup> As such a player, it needed a “significant, robust relationship with a strong partner.” The government had in fact been urging Aer Lingus to seek an alliance since at least 1992, but the airline’s financial problems made it an unattractive partner until it returned to profit in 1994-5. In March 1997, the government gave Aer Lingus a formal mandate to seek admission “into a major strategic alliance, with or without the transfer of equity” and in September 1998 the airline submitted a report that stressed the urgency of obtaining an ally.

Aer Lingus, the report pointed out, was (with Olympic) the only European flag carrier that had not yet joined an alliance:

The scope of network competition [it observed] has expanded significantly, as open skies allows airlines to compete more effectively for traffic outside their own origin and destination markets. Unaligned airlines are becoming increasingly isolated from significant traffic flows and their own markets are subject to significant competition.<sup>89</sup>

If Aer Lingus did not join an alliance, the report warned, it would find itself excluded from hubs in Europe and the US that could provide feeder traffic: it would become limited to point-to-point services to and from Ireland and would eventually be unable to sustain its current level of transatlantic services. The airline’s existing strategy, the report concluded bleakly, was becoming “increasingly untenable:” it would face “isolation and marginalization” (especially on the North Atlantic) as it was squeezed out of its markets by the alliances.<sup>90</sup> After a review of six proposals from other carriers, Aer Lingus decided in 1999 to become a member of the Oneworld alliance. Thus, from an initially ambitious and expansive strategy within and outside the single market, Aer Lingus gradually retreated to one that involved concentrating on one sector - its transatlantic routes - and protecting itself by becoming a junior partner to two of the world’s largest airlines (BA and American) and by developing a clearer and more distinctive niche strategy.

Left outside this process of incorporation was KLM, which had largely devoted itself to refining its alliance with Northwest. But its management recognized that to grow and protect itself against the incipient “mega-carriers,” KLM would need another major partner and a second European hub, given environmental restrictions at Amsterdam Schiphol. Its goal was to raise its share of European traffic from the 7-8% it had in the early nineties to about 15% - a growth that it calculated was necessary (given the limits of the Dutch market) to sustain its long-haul network.

KLM therefore went through a long, somewhat repetitive and ultimately fruitless series of negotiations, concentrating on two carriers - BA (with which it had at least two courtships) and Alitalia. Philosophically, BA was much the more natural ally of the two, since the Dutch and the British shared a liberal commercial and regulatory philosophy. For KLM, association with BA would bring great network advantages, while such cooperation would bring BA the continental hub it had earlier sought in Brussels through an aborted alliance with Sabena and KLM.<sup>91</sup> But in both 1992 and in 2000, direct bilateral talks with BA broke down, mainly over the issue of the relative valuations of the two companies in a joint venture carrier they proposed to launch as a way of merging their operations and (once more) over the question of an American partner.<sup>92</sup>

In between its two sets of talks with BA, KLM formed (in 1997) a more improbable alliance with Alitalia. This arrangement - bravely described by KLM’s president as offering a combination of “Italian drive, style and creativity ... with the pragmatism, business sense and serious attitude of the Dutch” - was driven by the need for a second hub - preferably one in a larger European state.<sup>93</sup> The new alliance aimed to create a joint hub at Milan Malpensa, and in the course of 1998 the two airlines drafted and signed a ten-year Master Cooperation Agreement which provided for a “virtual merger” of services (without any equity exchange): Northwest and Continental were to be the North American partners and the value of the transatlantic element was to be strengthened by an imminent open skies agreement between the US and Italy.<sup>94</sup>

KLM had thus opted - rather reluctantly - for strategy 5 (alliance with a larger carrier), but within eighteen months the alliance collapsed because of doubts about the long-term development and value of Malpensa and uncertainties about the privatization of Alitalia.<sup>95</sup> Within weeks, KLM had entered into its second round of negotiations with BA for a merger, but these collapsed after five months.

KLM had by this time acquired the reputation of being a difficult negotiating and business partner: as one commentator put it, KLM had “a string of failed marriages to its name.”<sup>96</sup> In fact, its alliances were not much less stable than those of the other small-country carriers, with their often bewildering shifts of strategy and changes of partner. But KLM faced the special problem of being an airline with a rather small domestic market and with stakes outside Europe that it expected potential partners to respect. Some critics argued that KLM failed to appreciate that such partners focused particularly on its small domestic market and were consequently less impressed by KLM’s market value than its own management, which focused more on its long-haul network and its experience and standards as Europe’s oldest airline.



## Conclusions:

This paper has explored the question of why and how small-country airlines in the EU have (with one exception) been able to survive the challenges presented by the single European market. One answer to the “why” question is clearly regulatory - the existence of nationality restrictions in agreements with “third countries” that discourage takeovers, as well as actual legal impediments to substantial foreign ownership.

But the economic survival of these airlines has also been due to the strategies that their managements have pursued in order to protect and expand their markets, to use resources more efficiently, and to obtain new capital (sometimes from government). With small domestic markets, such airlines initially had a choice between resigning themselves to being niche carriers within Europe (simply carrying passengers to and from their main cities, as Luxair does); trying to expand within the single market (as Aer Lingus did in the late eighties); and trying to establish or expand a range of long-haul routes that would generate more revenue (as KLM traditionally has).

The Aer Lingus experience (and that of some larger carriers) showed that the second strategy was very difficult to pursue successfully. Finnair managed to set up a hub in Stockholm but very few other flag carriers succeeded in establishing hubs outside of their home countries. The third strategy - that of building up a long-haul network - normally requires drawing on transit traffic from other countries, particularly larger countries, because smaller countries do not typically generate enough traffic to support economically-viable services on routes such as Helsinki to Tokyo or Dublin to Toronto. However, depending heavily on transit traffic is itself perilous because it makes an airline particularly vulnerable to recessions and political crises abroad. It also attracts the hostility of airlines that may feel that “their” traffic is being poached. Moreover, the offended airlines are likely to be major carriers such as Lufthansa or BA, since countries such as Germany and the UK offer large and tempting markets to carriers looking for transit traffic.

In the early years of liberalization, despite dire warnings about “mega-carriers,” it seemed that the single market would not seriously upset the distribution of market power between national airlines. Consumer advocates who expected an outburst of competition were disappointed. Though the larger airlines talked about (and invested in) expansion, their actions were in fact largely defensive: the long-standing (and much criticized) *modus vivendi* between state carriers seemed to have survived through a tacit agreement not to invade each other’s domestic markets - except sometimes through proxies. The crises that small-country airlines suffered in the early nineties reflected a larger crisis in the airline industry brought on by recession and the Gulf War: they were not the result of invasions by rival carriers.

But these crises did expose structural weaknesses in many airlines (both large and small) and

required considerable injections of capital that governments were increasingly unwilling or unable to provide. Under pressure to cope with the costs of industrial adjustment and the welfare state, governments in both larger and smaller Member States decided that, having helped out their state airlines with the heavy costs of reorganizing and buying new aircraft, it was time to force them to find capital elsewhere. For larger airlines, such as BA in the eighties and Lufthansa and Air France in the nineties, domestic capital markets were quick - even eager - to provide an alternative source of money. For the small-country carriers, however, the state sometimes recommended a “trade sale” of some shares to a foreign airline: such airlines were therefore headed away from a “stand-alone” strategy towards membership in one of the alliances that were beginning to form.<sup>97</sup>

In the ensuing tension between the wish to survive and the wish to be independent, one attractive solution was an alliance of small-country airlines. But this option faded after the collapse of the Alcazar negotiations in 1993 - an important turning point for all the carriers involved. The collapse of Alcazar showed in an exceptionally vivid fashion the increasing strategic importance of transatlantic alliances for all EU carriers: faced with a choice between creating a defensive alliance within the single market and developing an established relationship with a major US carrier, KLM and Swissair chose the latter (but not the same partner). Moreover, the subsequent Swiss attempt to create a successor alliance of smaller carriers showed the limits on a strategy that involved combining economically-marginal companies based in small markets. Two of the flag carriers involved collapsed into bankruptcy as a result of this strategy (or the way in which it was implemented).

In the late nineties, both pressure and prudence led most of the small-country airlines to seek membership of alliances that were headed by large-country airlines. The pressure stemmed not just from the wish of governments to privatize state-owned airlines, but also from the increasingly exclusive nature of global alliances that (as Aer Lingus recognized in its 1998 report) were encircling independent airlines and absorbing both European and long-haul traffic. The effect of such isolation would be to starve unattached companies of all but the most local, point-to-point traffic. Indeed, alliances would also invade domestic markets (as Finnair discovered when the Star Alliance bought its main domestic rival, and as SAS - the initiator of this raid - discovered when BA and KLM created alliances with Danish and Norwegian airlines).

The strategies of small-country airlines therefore converged on one common strategy, that of taking shelter in a global alliance, even if it meant in effect becoming the junior partner of a larger airline. SAS became a junior partner of Lufthansa in the Star Alliance, while Aer Lingus and Finnair became junior partners of BA in the Oneworld alliance. Sabena and TAP became (or were on the way to becoming) the junior partners of Swissair. KLM remained “single in the single market,” but only after successive attempts to cooperate with larger carriers.

Having observed this process, we might well ask: what is the difference between the “consolidation” that was forecast in the eighties and the “network incorporation” that has occurred? Under consolidation (meaning a process of merger and integration), while the company loses its formal independence, much of its network and some of its staff and equipment might be preserved. In the current form of incorporation into alliances, while companies keep their formal independence,

their decisions about marketing and operational matters are likely to be constrained by the wishes of their partners. Moreover, alliance membership is not essential to survival: Olympic Airways, Luxair and (now) TAP are not members of alliances, neither are a substantial number of European scheduled and charter airlines. Further, alliance membership is not a guarantee of survival.

But what alliance membership does offer to small-country airlines is, in Jan Stenberg's words, the opportunity to "operate in a global market without having a global presence." SAS can, through code-sharing and cooperative marketing and technical arrangements, draw on the markets and resources of other carriers (notably larger carriers) for little extra cost, and can do so without losing the distinctive national identity (or in this case, Scandinavian identity) that has been so important for small-country airlines and their governments.

Regulatory provisions have played a paradoxical role in shaping this "bargain" for small-country carriers. On the one hand, nationality provisions in bilaterals have provided a disincentive to the physical absorption of airlines by other carriers. On the other hand, both nationality provisions and rules about cabotage have provoked airlines to create global alliances as a second-best way of integrating markets when regulation prevents taking over a foreign airline and prohibits operating domestic services in a foreign market. Thus regulation has both given small-country carriers the opportunity (though not the resources) to survive and prompted the creation of the alliances that now offer them the opportunity to survive and to grow.

For those who still care about the symbolism of flag carriers, this outcome is surely welcome. For those who care more about efficiency or competition, it is probably either irrelevant or even unwelcome. From a consumer's point of view, there may be little to choose between an industry made up of three or four "mega-carriers" and one made up of three or four "mega-alliances." Both offer the virtues of a large, well-integrated network and the possibility of *lower* fares (because of economies of scale); both present the danger of reduced choice and a consequent risk, in the future, of *higher* fares because of monopoly power.

In this sense, the ultimate struggle within the single market is not that between larger and smaller flag carriers or, indeed, that between global alliances, but the struggle that will occur if and when the "low-fare airline" concept is applied to long-haul routes as well as to routes within Europe. Before that can happen, the Chicago system of regulation will have to be substantially relaxed to allow airlines to enter and exit international routes at will. The history of both the airline industry and its regulators does not suggest that such liberation is imminent.

#### NOTES:

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1. Instone (1938, 105) (cited in Sampson 1984, 28). Commenting on the proliferation of

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European airlines in the twenties, the veteran historian of the airline industry, R.E.G. Davies, remarks that “it did not make sense for every country to have its own airline – just as it was not economic sense for every county in England to have its own railway”(Davies 1964, 68).

2. The countries mainly examined in this paper are Belgium, Finland, Ireland, the Netherlands, Portugal, and the countries supporting the SAS consortium (Denmark, Norway - though not an EU member - and Sweden). Switzerland is a special case because of its self-exclusion from the EU. But Swissair (before its demise) played a major role in the strategizing of small-country airlines through its effort to create a presence in the single market by heavy investment in EU Community carriers.
3. Namely, “Swiss” (with the highly-recognizable white-cross-on-red tail previously used by Swissair) and “SN Brussels Airlines” - “SN” having been the flight code used by Sabena. The symbolism of “Brussels” rather than “Belgian” is less clear.
4. The *Guinness Book of Records* lists this as the world’s shortest scheduled air service, taking on some occasions as little as 58 seconds (McFarlan *et al*, 1992, 386).
5. Antoin Daltùn, business planning manager, Aer Lingus, quoted in Donoghue (1990, 41).
6. As a journalist remarked about Aer Lingus, it was advantageous to have “a geographic position that is isolated from intra-European traffic flows and the accompanying temptation for competitive blood-letting” (Donoghue, 1997, 55).
7. Teresa Lopes, deputy general finance director, quoted in Lennane (1998).
8. A “great circle” route is “the shortest course between two points on the surface of a sphere” (*Encyclopedia Britannica* ([www.britannica.com](http://www.britannica.com))).
9. For analytic purposes, we include SAS and Finnair in group (4) since they offer an interesting comparison with other “peripheral” carriers.
10. Such dependence arose partly from the earlier involvement of European airlines in contributing to the logistics of empire and partly from the difficult competitive challenge presented by the railways to airlines within Europe.
11. See Katzenstein (1985, 82).
12. Republic of Ireland, 1994, 7, section 1.5.
13. The Chicago Convention gave rise to the notion of five “freedoms of the air,” each of which refers to a type of traffic right. The “sixth freedom” (itself a contested term) refers to an operation in which an airline based in country A flies passengers between countries B and C on flights connecting in country A.

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14. The so-called “KLM concept” involved creating a hub at Amsterdam Schiphol and attracting transit passengers by low fares, good connections and even overnight accommodation (see Dierikx, 1998, especially 140 and 145: the ramifications of this strategy are also examined in Dierikx, 1999). Other airlines resented KLM’s activities, but at least the Dutch were consistently liberal in offering rights to other countries. Belgium, by contrast, tried to combine protectionism with a transit traffic strategy, and Sabena quickly found its expansion restricted by trading partners (see Vanthemsche, 2002, especially 110-111 and 170).

15. A “Community carrier” is any airline established in one or more EU Member-States that is “substantially owned and effectively controlled” by EU citizens (“substantial ownership” being defined as holding at least 51% of equity). Swissair is therefore not a Community carrier, though it tried to obtain the benefits of this status indirectly by buying 49.5% of Sabena in 1995. SAS is a Community carrier by virtue of the majority Danish and Swedish holdings. An exception to the monopoly of intra-European routes by Community carriers are so-called “fifth freedom” services on which a non-EU airline has rights acquired before 1986 to carry passengers between European cities. Very few non-EU airlines in fact still exercise such rights, though they may appear to do so because of “code-sharing” arrangements with alliance partners.

16. This is a significant example since in 1991, when traffic rights belonging to Pan American and TWA for services to Heathrow were sold, BA bought rights to fly between Paris and New York. Because of the persistence of the bilateral system on long-haul routes, BA has never been able to exercise these rights since the French and US governments have (not surprisingly) been unwilling to admit BA to this route.

17. Such coordination normally involves the practice of “code-sharing”(under which one airline’s services are marketed as offered by one or more alliance partners - for example, a BA flight advertised also as a Finnair or American Airlines flight by use of the designators “AY” or “AA”). Code-sharing has frequently been criticized as deceptive and is now subject to strict regulation that requires airlines to indicate when a flight advertised as its own is actually operated by another carrier.

18. To take a different example, had Swissair raised its holding in Sabena above 50% (as the Belgian government proposed), a double challenge might have arisen - a challenge from EU airlines to Sabena’s status as a Community carrier and a challenge from non-EU airlines to its status as a Belgian airline.

19. Helge Lindberg, SAS Group Vice-President, reportedly said that he doubted if SAS could “survive alone as a major intercontinental airline” (quoted in Ghoshal, Lefébure, Jorgensen and Staniforth, 1988, 2).

20. Quoted in Webb and Betts (1992).

21. Lindberg, quoted in Ghoshal, Lefébure, Jorgensen and Staniforth (1988, 2).

22. Quoted in Reed (1988, 33).

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23. Quoted in Reed (1988, 33). Kennedy was also convinced that smaller airlines had distinct advantages over their larger competitors
  24. Finland had applied for membership of the EU in 1993, but was not expected to be admitted before 1995. In 1994, however, Finnish airlines (in practice, Finnair) were given permission to operate within the single market with the same prerogatives and requirements as existing Community carriers.
  25. As paraphrased in Lefer (1991, 31): see also Hill (1998B, 63).
  26. Quoted in Guild (1995, 51).
  27. Lehmann Brothers (1993, 56). *A propos* of possible alliances, the chairman of TAP, Manuel Ferreira Lima, said in 1997:

The position of TAP in the future must parallel that of Portugal in the European and global markets. This is a little country and this is a little company which would like to maintain a high degree of independence. (quoted in Cameron, 1997, 57).
  28. See Doganis (1991, 96-8). Whether these goals were compatible with the Commission's goals of creating greater competition and more choice for consumers is, of course, a separate question.
  29. On the "aviation business" model, see Doganis (2001, 215).
  30. TAP joined the Swiss-led European Quality Alliance of smaller airlines but, as described later in the paper, Swissair subsequently withdrew from an investment in TAP and then went into bankruptcy.
  31. Ghoshal, Lefébure, Jorgensen and Staniforth (1988, 5, 7, 10-11).
  32. Feldman (1991, 102).
  33. Vanthemsche (2002, 273-4).
  34. Lehmann Brothers (1993, 46).
  35. Between 1990 and 1994, SAS lost in total SK3, 191 million (\$549 million), while debt built up to SK19.6 billion (\$2.8 billion).
  36. Between 1991 and 1995, SAS's staff fell from 25,000 to 20,000.
  37. On the change in strategy, see Flint (1995) and Carnegy (1995).
  38. Carnegy (1995).

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39. By the early nineties, KLM (with a staff approaching 26,000) was flying to over 80 destinations outside Europe and performing nearly 90% of its mileage on long-haul services: over 65% of its revenue came from such services, with 25% coming from North Atlantic routes.
  40. *Economist* (1963, 139).
  41. KLM typically carried less than 10% of its annual traffic on intra-European routes.
  42. The so-called American “invasion” arose from consolidation of the American industry following deregulation. The “mega-carriers” thus created had very large (and expensive) hubs that offered traffic for international services.
  43. “History,” in Luxair website, *www.luxair.com*.
  44. It was only in 1999 that Luxair launched a service outside the EU, to the US. But Luxembourg had long been a favored destination for charter flights from North America.
  45. On Finnair’s strategy, see (e.g.) Feldman (1997), Glab (1992), Hill (1998B and 2001), Lefer (1984 and 1991) and Nelms (1993).
  46. Glab (1992, 19); Lefer (1991, 31).
  47. In 1993, Finnair predicted that, with growth in the Russian economy, it could be flying as many as 160 million Russian passengers on international services within 25 years (Nelms, 1993, 85). By 1998, it was earning 30% of its revenue from the Russian and Baltic markets (Hill, 1998B, 86).
  48. Elliot (1995) remarks that, in Finnair’s case, the problem with relying on “sixth freedom” traffic was that such traffic provided low yields and was “notoriously unstable.”
  49. The same applied to Finnair’s north-east Asian “niche,” discussed below.
  50. Reed (1988, 32); Donoghue (1990, 34, 40).
  51. Cathal Mullan, CEO of Aer Lingus, quoted in Donoghue (1990, 34).
  52. Reed (1988, 34).
  53. Donoghue (1990, 35).
  54. Aer Lingus ended all but two of its six European services from Manchester and did not revive them after it had returned to solvency.
  55. Quoted in Donoghue (1997, 58).
  56. Quoted in Donoghue (1997, 58).

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57. Quoted in Donoghue (1997, 57).
58. As a result of the Shannon policy and its own low fares (partly dictated by the government's wish that it promote tourism), Aer Lingus (flying three twenty-year-old 747s) had lost money on its transatlantic services every year but one between 1969 and 1993 (Donoghue 2000, 45: see also Donoghue 1994, 84). The new emphasis on transatlantic travel was justified by the dramatic growth in the Irish economy and was set out in a 1998 report (Aer Lingus, 1998, 4). In 1994, a government report recommended that Aer Lingus be relieved of direct responsibility for encouraging tourism: see Republic of Ireland (1994, 17).
59. On the impact of decolonization on selected European flag carriers, see Staniland (forthcoming).
60. Davies (1964, 286).
61. At one point, TAP had four surplus Boeing 747s parked at Lisbon airport. On TAP, see Cameron (1997); Hill (1998A); Lennane (1998); and Wankoff and Buckley (1998).
62. See Vanthemsche (2002, especially 23-26, 60-69, 102-107 and 122-126). Before 1960, the airline was partly owned by the administration of the Belgian Congo.
63. See Vanthemsche (2002, 263).
64. Lefer (1991, 31); Lefer (1984, 52).
65. Guild (1995, 52).
66. A similar technical organization, Atlas, was created by Sabena, Air France, Lufthansa and Alitalia.
67. This project, involving Air France, Alitalia, Lufthansa, Sabena and (for a time) KLM, envisaged the creation of a consortium in which the constituent companies would, in addition to coordinating their operations and equipment, share revenue according to pre-established quotas.
68. In particular, KLM and Sabena went through periodic negotiations about an alliance (with the further possibility of creating a "Benelux" airline in cooperation with Luxair). A variant of this approach was an abortive plan, developed in 1988, for the creation of an airline (to be named "Sabena World Airlines" [SWA]) in which BA and KLM would each hold 20% of the equity, with Sabena itself holding 60%.
69. Feldman (1991, 104, 106).
70. The alliance was named after the four-sided Moorish fortresses in Spain.
71. Barnes (1993). The combined traffic of Austrian, KLM, SAS and Swissair in 1991 was 30.6



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million (more than either BA or Lufthansa).

72. Otto Loepfe, quoted in Feldman (1994, 33).
73. Shifrin and Sparaco (1993, 29).
74. Quoted in Shifrin and Sparaco (1993, 30).
75. Quoted in Reed (1993, 34).
76. Technically, it was the SAir Group (of which Swissair formed a part) that bought the stock.
77. Vanthemsche (2002, 298-9). At one point this alliance was disparagingly referred to by Delta's American rivals as "Delta and the nine dwarfs."
78. Criticisms noted in Vanthemsche (2002, 300).
79. João Marques da Cruz, quoted in Lennane (1998).
80. As Vanthemsche (2000, 295) observes, Sabena saw "its range of choices diminishing inexorably ... From alliance to alliance (proposed or concluded), we see the slow erosion of Belgian autonomy and the increasing power of the foreign partner, whichever it might be" (author's translation).
81. Lefer (1991, 31).
82. Feldman (1997, 85); Hill (1998B), 65.
83. Quoted in Flint (1995, 49).
84. In the case of Finnair, the 1993 Lehmann Brothers report concluded that while the alliance was "strategically sound," it created the danger that Finnair would "be reduced to the role of feeding passengers between Helsinki and Frankfurt, and Lufthansa [would] reap the benefits of higher load factors on both its European and intercontinental flights"(Lehmann Brothers 1993, 54). The *Financial Times* commented that SAS would be "the junior partner" in its alliance with Lufthansa (Barnes and Carnegy, 1995).
85. Barnes and Carnegy (1995). However, some tensions emerged during the first two years of the alliance. For example, when in 1996 a Lufthansa official reportedly suggested that the alliance might lead to a merger, Jan Stenberg, the CEO of SAS, retorted that such an arrangement would not be "a merger of equals" and would lead to SAS being "swallowed whole" by Lufthansa (McIvor 1996 (the phrase "swallowed whole" is McIvor's)).
86. In sealing its relationship with Lufthansa, SAS had to abandon its alliance with Continental and its membership in the EQA.

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87. Jan Stenberg, quoted in McIvor (1996).
  88. Quoted in Donoghue (1997, 55).
  89. Aer Lingus (1998, 15).
  90. Aer Lingus (1998, 9).
  91. See endnote 68.
  92. Reportedly, BA wanted American Airlines as the US partner while KLM preferred to stay with Northwest. Another issue was the fear that KLM would lose the traffic rights attached to its Dutch nationality if a majority of the shares of the new company were owned by BA. According to *Airline Business*, in 2000 the US government did warn “that KLM could lose its bilateral rights if BA took control” (Baker 2000, 9).
  93. Quoted in Sparaco (1998, 38).
  94. Sparaco (1998, 38). The two airlines would remain separate legal entities. Continental Airlines had become an alliance partner of Northwest.
  95. On the Malpensa saga, see the excellent account in Hine (2000).
  96. Thornton (2000, 7).
  97. As in the Belgian, Irish and Portuguese cases (the possibility of a sale of Aer Lingus equity to BA was brought up but never implemented).

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