

Corporate Breakdown

Edition 8 – March 2003

analysis of the real stories behind corporate merges and acquisitions

FLYING INTO TURBULENCE:

TROUBLED TIMES FOR THE EUROPEAN THE AIRLINE INDUSTRY

by Julian Oram

For years, the aviation industry was one of the most powerful symbols of the modern era, representing the promise of unlimited mobility, international co-operation and technological progress that have been the shining face of globalisation. However, while the industry boasted impressive growth figures throughout most of the 1990s, hidden forces were already starting to undermine the business foundations of the major airlines. But, like a cancer ignored for too long, by the time the symptoms of this malaise had begun to show it was already too late.

The first cracks within the armour of the global airline giants appeared as early as 1999, when the industry posted a 55% decline in profits from the previous year. By the end of the following year, industry analysts were predicting major belt-tightening operations would be needed within a number of the established European airlines if long-term viability were to be maintained. After September 11th, 2001, the precarious position of these companies was brutally exposed as the industry, already teetering on the brink of financial disaster, was dealt a devastating blow.

What has followed has been a massive and painful restructuring of the industry. In the months since September 11th, dozens of airlines in Europe and around the world have slashed routes, shed jobs, filed for bankruptcy, seen their share prices plummet, sold their assets, and in some cases, ceased to exist altogether. Below we look at how the industry became so vulnerable to shock, explore the coping mechanisms that the airlines have used to adjust to the current commercial climate, examine the impacts of these changes on airline workers and consumers, and assess some of the issues that the industry has yet to face up to – particularly dealing with the costs of climate change.

HOW THE GOOD TIMES TURNED SOUR

The airline industry has, by its very nature, come to embody the age of globalisation. Over the past three decades passengers have come to expect universal standards of comfort, care and safety from the industry, with thousands of flights criss-crossing the world's stratosphere every day. At the end of the 20th century, some 4 millions people took to the skies every day, with a quarter of a million people airborne at any given moment in time.ⁱ The big airlines have also marketed themselves as the indispensable accomplices of the modern businessperson – both as conveyors and as corporate players in their own right, with large airlines linking with hotel chains, credit card providers, car hire firms and other companies catering to the needs of the ever-more demanding world traveller.

Yet ironically, as economic globalisation has gathered pace, the airline industry has looked increasingly vulnerable, and once rock-solid companies have buckled under the strain of the rapidly changing commercial aviation market. For many the trouble started following the deregulation of the industry in the 1970s and '80s. This process began in the United States in

1978, when the federal government decided to stop regulating fares and routes in order to open the industry up to competition from new cut-rate carriers. However, without the government's intervention, the major airlines either bought out or drove out most upstarts, with only a small handful managing to thrive in the bully-boy market controlled by the established carriers. The result in America was consolidation in the industry, leading to less consumer choice and higher fares.ⁱⁱ

In Europe, deregulation happened more slowly through three waves of policy change. The first occurred in 1987, when the European Union allowed cost-related fares and certain types of discount fares to be introduced in tandem with negotiated prices. A second set of policies dealing with pricing rules and capacity splits followed two years later. But the most comprehensive regulatory reforms were initiated in 1993. Notable amongst these were the opening up of intra-EU routes to all EU carriers; permission for EU airlines to obtain an operating license in any member state; harmonisation of technical, fitness criteria and financial structure rules; and the ability for airlines to fix their own fares on services within the Union, subject to certain consumer safeguards. From April 1st, 1997, EU airlines could also operate on domestic routes within all member states.

Deregulation in America had two basic effects on the industry. On the one hand, it opened the doors for a host of new, short-lived regional airlines, which brought down prices on certain routes and undercut some of the larger incumbents, hastening the demise of big names like PanAm, Eastern and TWA. At the same time, it accelerated the development of the modern "hub" and "spoke" airline system, in which the major airlines place a premium on dominating a major airport, something that is almost impossible for smaller market entrants to do. This had the effect of marginalising the new airlines, many of which did not survive their first few years.

The problem with deregulation is that airlines are not a naturally competitive industry. They require very expensive capital equipment that needs to fly mostly full to be cost effective. And airlines depend on public facilities, namely airports, which are publicly subsidised in a way that works to the advantage of the larger carriers. The net result of deregulation in the US was therefore consolidation within the airline market, with knock-on effects on the entire international aviation industry. By 1998, more than half the world's jet fleet were operated by just 17 airlines, with more than half of all passengers flying on an airline belonging to one of four mega-alliances.

In Europe however, the slower pace of deregulation and history of state backing for the national flagship carriers have kept the market relatively fragmented. Rather than undertaking mergers and acquisitions, European airlines have attempted to share costs and keep passenger numbers by setting up alliances between themselves and other international carriers. Although partly successful, concentration was seen by some as inevitable. In 2001, the Chairman of British Airways, Lord Marshall, warned that the national affiliations of the European airlines was making it difficult for them to compete globally, and declared that the industry is "crying out for consolidation"ⁱⁱⁱ.

Marshall's comments came amid increasing concern over the state of the industry in Europe. The airline business is precarious at the best of times. Airlines must contend with fluctuating oil prices, high operating costs (including flight crew, aircraft maintenance and landing charges) and uncertain passenger numbers from year to year – an issue that makes investment in expensive assets such as aircraft fleets a risky venture.

Airlines' profitability is also closely tied to economic growth and trade. During the early 1990s, the industry suffered not only from world recession but was further depressed by the 1991 Gulf War, when the number of international passengers dropped for the first time. The financial difficulties were exacerbated by airlines over-ordering aircraft in the boom years of the late 1980s, leading to significant excess capacity in the market. Members of the International Air Transport Association (IATA) suffered cumulative net losses of \$20.4bn in the years from 1990 to 1994.^{iv}

Even in the boom years of the late 1990s, the industry only managed to keep its head above water. Despite many airlines undertaking aggressive cut cost exercises to increase load factors, the IATA airlines' profits were still only \$5bn in 1996, less than 2% of total revenues – and this at a time of renewed economic growth.

As global growth slowed in 2001, a number of airline companies were once again falling into the red. Several carriers on both sides of the Atlantic suddenly looked over-stretched, with bloated fleets and too many unprofitable routes. Then, suddenly, an industry already struggling to cope with short-term profitability problems was hit by a truly devastating event. The attacks in America on September 11th wiped hundreds of millions of dollars from the value of the major airlines at a single stroke. But they also knocked a huge dent in the flying public's confidence of the industry, and passenger loads plummeted over the following weeks and months. Those events also accelerated the slowdown in the world economy, meaning that demand for both business and personal travel was in any case reduced.

The consequences of these combined factors were swift and severe. Already on course to lose \$3 billion for the year, the airlines ended up posting losses of \$13 billion in 2001. According to the IATA, the world's airlines have lost \$30 billion over the last two years.^v Several European airlines that had already been on the brink of collapse were sent sailing over the edge, with Swissair, Aer Lingus and Sabena being prominent victims. Other European carriers meanwhile resorted to drastic measures to minimise their losses and stay solvent. All shed jobs, slashed routes, stopped aircraft orders or put freezes on hiring.

However, while European airlines have struggled to keep their heads above water, they have fared comparatively well next to their US counterparts. Americans have been more reluctant to fly than Europeans since September 11th, and the demand for air travel in the States has fallen about 15% - twice the decline in the European market.^{vi} This has been catastrophic for the major American carriers, which lost nearly \$12 billion in 2001. US Airways, United Airlines and Hawaiian Air have all had to file for Chapter 11 bankruptcy, while Delta, Northwest and Continental were all forced to announce drastic cost-cutting measures, including route restrictions and massive redundancies. AMR Corp., the parent company of American Airlines, has recently been in talks in a last-ditch effort to avoid the world's biggest airline also filing for bankruptcy. Only the newer budget airlines such as JetBlue, Southwest and AirTran have been left relatively unscathed.

Recent events have done little to take the pressure off of the airlines. After piling up more losses in 2002, the industry has suffered further set-backs in the new year from the war in Iraq and the outbreak of the Severe Acute Respiratory Syndrome (SARS) virus. The American Air Transport Association is predicting that these factors could translate into losses of around \$13 billion for this year, and lead to a further 70,000 job cuts in the United States.^{vii}^{viii} The

industry could be struggling for some time to come, with recovery not anticipated until at least early 2004.

There is now considerable speculation that the industry will soon undergo rapid consolidation in Europe, with smaller carriers unlikely to resist the gravitational pull towards largest airlines – Lufthansa, Air France & British Airways.^{ix} The new entities created out of these intra-European acquisitions are in turn likely to forge alliances – and possibly even merge with – the major US airlines, creating a handful of global super-carriers that will compete with a similar number of regional no-frills airlines.

FEELING THE PINCH

As passenger loads plummeted and airline debts mounted, the surviving large carriers have undertaken major organisational adjustments to stave off the threat of bankruptcy. According to the International Labor Organization (ILO), the global airline industry shed close to 400,000 jobs in the three months following September 11th, 2001. Job cuts of various sizes were announced by practically all of the main European carriers. KLM sacked 2,500 workers, Sabena 12,000, Virgin Atlantic 1,200, Swissair 9,000 and Alitalia 2,500.^x

And the industry keeps haemorrhaging staff. Responding to depressed market conditions, European airlines continue to cut back services and make redundancies. After declaring that it had lost Sf582m in the first nine months of 2002, Swiss airlines announced in November that it was cutting 300 jobs among pilots, cabin crew and ground staff, although it also said it was taking on another 200 technical and IT services staff to reduce flight cancellations.^{xi} British Airways meanwhile has been forced to plan a renewed £450m cost-cutting programme as it waits for an upturn in market conditions. The fresh round of cuts are in addition to the £650m cost-savings strategy announced in BA's radical future size and shape programme a year ago, which included a target of 13,000 job losses by March 2004.^{xii} Other major European carriers to warn of further cuts in recent weeks include Lufthansa, Finnair, SAS, Air France and KLM. The sale by the latter of its cheap-flights subsidiary Buzz to rivals Ryanair has also been accompanied with the news that the acquisition will require huge cost-cutting. About 25% of Buzz's pilots, 80% of cabin crew and almost all administrative staff will lose their jobs.

Reacting to the news, Jim McAuslan, general secretary of the British Airline Pilots Association, expressed dismay at Ryanair's ruthless approach. "This is not the sort of employment practice we expect to see in the UK," he stated. "We will be taking very urgent legal advice." The unions believe Ryanair may be breaking European directives on consultation and recognition. A GMB spokesman said: "It is quite outrageous that in the 21st century, in a country such as Britain, that my members should be told they're being made redundant in a press release. We will be going to see our barristers on Monday."^{xiii}

The Buzz takeover indicates a deeper concern amongst airline unions that the industry's current woes are being utilised as a cynical opportunity to undermine collective bargaining rights. In a report for the ILO, Professor Peter Turnbull of Cardiff University Business School warned that airlines "...seem to be exploiting current difficulties to push through more radical cost cutting programmes than is strictly warranted, often without proper consultation with the workforce".

But its not just airline staff who are feeling the pinch. Shareholder and pension funds with heavy investments in the airline industry have lost millions of Euros as the major airlines have

slid down the European market league tables. Taxpayers on both sides of the Atlantic are also being expected to bail out the ailing airlines – including low-income workers who can't afford to use the services they are supporting through their taxes. In the aftermath of September 11th, Congress approved \$5 billion in emergency hand-outs to the airlines hit by massive losses in the wake of the attacks. While this was an understandable reaction to stabilise the industry, it was followed by a less easily justifiable decision to hand out a further \$10bn in loan guarantees. European airlines have argued that these subsidies benefit American carriers unduly, translating into lower operating costs and enabling US airlines to offer cheap tickets.^{xiv, xv}

The EU, in contrast, has maintained its strict competition policy rules against allowing member governments to directly subsidise their airline industries. The Commission has restricted post-September 11th aid to off-setting the ‘exceptional losses’ incurred when transatlantic routes were shut down for several days, as well as meeting some of the increases in insurance and security costs faced by the airlines.

However, European carriers have continued to receive government assistance through less direct measures. The most obvious of these are the lack of VAT on aircraft, airline tickets and duty-free sales; the absence of excise duties levied on aeroplane fuel; and the costs of building and maintaining the surface transport infrastructure that serves airports. In 2001, the Green Party of England and Wales, estimated that the overall hidden economic costs of the European Union's aviation sector to be €23.5 billion a year.^{xvi}

While workers, shareholders and taxpayers have all felt the pinch, many analysts have declared airline consumers to have been one of the few winners of the recent turmoil within the industry. But there is conflicting evidence to support this case. While European consumers have seen ticket prices fall as the budget airlines leap to fill the voids left by the contracting flagship carriers, passengers have lost out from fewer flights and fewer carrier options, as well as the having less certainty of guarantees over ticket purchases. For example, consumers' organisations have expressed dismay at Ryanair's plans to axe all of Buzz's flights in April. Thousands of passengers who have already paid for tickets will get refunds, but no compensation.^{xvii}

UNCHARTED SKIES: FUTURE ISSUES CONFRONTING THE INDUSTRY

While many within the industry are anticipating clearer skies ahead, a series of new challenges loom ahead on the horizon. The airlines are unlikely to see a return to the heady days of the 1990s, when Western holidaymakers sought out ever-more exotic destinations and business travellers regularly took to the skies in premium cabin classes. Some now predict that the lasting psychological impact of September 11th, combined within an uncertain global economic and political climate, will encourage more and more people to take holidays close to home, or to choose alternative methods of transport. Furthermore, increasingly sophisticated communications technologies have made it less necessary for corporations to send their staff in expensive and time-consuming foreign trips, when the same results can be achieved through video-conferencing and real-time peer-to-peer on-line networks.

There is also the issue of airport and air traffic capacity, which in some places has already been reached. The construction of new runways, airports and supporting infrastructure is causing growing headaches for planners and local governments, and is being strongly opposed by citizens groups and environmentalists concerned about the impact of increased noise levels, traffic congestion, habitat loss and air pollution. It has been estimated, for example,

that satisfying the forecast demand for air travel growth in the UK would require a new runway to be built every 4-5 years somewhere in the country.^{xviii}

But perhaps more crucial is the bigger issue of aviation's growing contribution to greenhouse gas emissions, and hence climate change. Airline emissions are the fastest-growing contributor to greenhouse gases. In 1992, 3.5% of global warming was attributed to flying, yet by 2050 the UN thinks this will rise to 7%.^{xix} Momentum has been growing to impose an international aviation fuel tax to account for the environmental costs created by these emissions. Shortly after September 11th, the European Union called on the rest of the world to tax aviation fuel as a way of curbing the environmental impact of air travel. While the timing of the announcement was miserable for the airlines, it signalled the commitment of European countries, led by Germany and Sweden, to tackle the unsustainable rise in aviation fuel consumption and implement the "polluter pays principle". A recent paper for the European Commission calculated that to pay for the environmental damage caused by flights passengers would face a charge of about €45 per 1,000 km travelled.

Switzerland and Sweden have already introduced a system linking landing charges on exhaust emissions. Now the British government is considering a drastic increase in airline levies. In a statement issued in March 2003 by the Transport Secretary Alistair Darling, the UK government surprised many by announcing that it is considering a tax increase of as much as 75% on airlines to compensate for their damage to the environment. A joint consultation paper by the Treasury and Department for Transport put the "national cost" of global warming caused by air travel at £1.4bn a year, rising to £4.8bn by 2030. At present, carriers contribute just over £800m a year to the UK Treasury in air passenger duty. To meet the full price of climate change, this will have to rise by three-quarters. The document notes that "full environmental costs are not factored into the prices paid by those who benefit from aviation," and states that there is a clear case for government intervention^{xx}

The airline industry has been resisting the prospect of any such tax for some time. The Germany-based air carriers association BARIG have expressed concerns about the proposed taxation of kerosene in commercial aviation. The association has warned that an EU aviation fuel tax would be unnecessary and counterproductive, and could even be illegal. BARIG Chairman summed up the airlines' opinion as follows: "Such a tax would not only provoke counteractive effects on the entire development of international aviation business, but would also be incompatible to national, European and international law".^{xxi} He also argued that such a tax would discriminate European carriers with respect to airlines that have their base of operation in countries without a fuel tax, and suggested that improvements in efficiency from new engine technologies would offset any future growth in air transport.

Unfortunately for the industry, such arguments are not likely to hold the Commission or member governments at bay for much longer. New technologies are not offsetting current growth in emissions, and if predicted flight increases occur the effects on climate change are likely to be huge. Nor can Europe hide from its responsibilities simply because other governments have failed to implement such measures. As with all such steps the momentum created by the EU would have a galvanising effect on other governments to follow suit – especially those that are also committed to implementing the Kyoto Protocol on combating climate change. Indeed, by imposing a tax upon landing, the EU could effectively penalise any polluting airline using an EU airport – minimising the discriminatory impacts on European carriers.

However, necessary as such measures might be, there is a concern that the airlines will try to skirt around paying such costs. Because the aviation industry crosses borders, it can avoid the reach of nations. A new fuel tax across Europe might just see airlines fill up outside the continent. Fortunately, there are ways of forcing change - one is an emissions toll which could be charged via Europe's air traffic control network. The cost would be passed on to passengers. Another would be an emissions trading regime, rewarding airlines with clean fleets and penalising those with polluting ones. Both measures are being considered by the Commission.^{xxii}

CONCLUSIONS

Despite a confident external veneer, European airlines had in reality been struggling to cope with major structural changes within both the industry and the overall economy long before September 11th. But the attacks on that day led to a momentous step change in the history of the industry. Overblown fleets and unprofitable routes went from a short-term profitability drain to a vortex out of which money began to bleed in torrents. Within months the industry had shed hundreds of thousands of jobs, witnessed a number of prominent bankruptcies and had to face up to the prospect of losing money for months to come.

The on-going crisis in the industry is likely to act as the trigger mechanism for a process of consolidation amongst European airlines that was viewed by many within the industry as inevitable ever since the last wave of deregulation in the mid-1990s. The likelihood is that the three largest airlines are likely to buy out their smaller rivals, creating several European conglomerates that may, in turn, link up with the major US carriers to form a handful of massive commercial aviation giants, competing against a small number of successful budget airlines.

Regardless of what happens with consolidation, the European airline industry will not be able to ride out the storm and hope things will eventually return to how they were in the good old days. New economic circumstances – including evolving business practices and a cautious flying public – will put a brake on air travel expansion. More fundamentally, however, environmental constraints at both the local and global levels will force the industry to reassess its future, as ticket prices begin to internalise and reflect the true costs of air travel. The likelihood is that these environmental imperatives will drive down demand for flights even further. The industry is therefore likely to contract in the long-term, and the airline companies will have to adapt their business models to offer flexible and cost-effective services that leave a light ecological footprint. The period of turbulence, it would appear, has only just begun.

NOTES

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ⁱⁱⁱ *BBCNews Online* “Airlines to embrace consolidation” 21 November, 2001.

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^{iv} Anon. “The Airline Industry” <http://adg.stanford.edu/aa241/intro/airlineindustry.html>

^v *Reuters* “Europe airlines sink below immediate Sept. 11 lows” March 28th, 2003.

^{vi} *The Guardian* “US airlines still reeling after September 11” August 15, 2002

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^{xvi} **WHITELEGG, J; FITZ-GIBBON S. AND CROOK, S. 2001. AVIATION'S ECONOMIC DOWNSIDE GREEN PARTY OF ENGLAND AND WALES.**

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^{xviii} Council for the Protection of Rural England. “Aviation: the looming threat to our countryside” CPRE Campaigns, November 26, 2002. <http://www.cpre.org.uk/campaigns/aviation/>

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^{xxii} GuardianUnlimited “Darling's dilemma” February 28, 2003
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