Profits take off; Brexit looms

BTG Global Advisory considers airline profitability and international competition, notably the impact of low-cost airlines consolidation, expansion to transatlantic routes, and labour and security challenges. We examine concerns about Brexit, which remains the most pressing threat to the UK aviation industry.

Financially, the airline industry had a robust year in 2017 – in the world, in Europe, and specifically in the UK. Growth in revenues and profitability is expected to continue through 2018. That said, many uncertainties remain, including questions about rising costs, labour and security threats. In the British market, new competition has emerged as Norwegian and other carriers assert themselves on transatlantic routes. At the same time there was more consolidation within Europe, and the UK airline industry saw the end of two established brands in 2017 with the shutdown of Monarch Airlines and the transformation of Thomson Airways into TUI Airways. And the shadow of Brexit looms large, since the UK's exit from the European Union brings great uncertainty for commercial aviation. This report details the successes and challenges for British and European airlines.

Growth and Profitability

The European Commission spelled out the role of the commercial airline industry in June 2017: "Aviation is crucial for the European Union. It creates jobs, drives economic growth, facilitates trade and allows people to travel. European aviation represents 26% of the world market, contributing €510bn annually to Europe's Gross Domestic Product, and supporting 9.3 million jobs in Europe. In 2015, over 1.45 billion passengers departed or arrived at EU airports.

"Air travel has substantially increased since the creation of the EU's Single Aviation Market 25 years ago. The number of daily flights has increased from less than 10,000 in 1992 to around 23,000 in 2016. In addition, passengers now have access to more destinations. Today there are around 7,400 routes compared to less than 2,700 in 1992."

For the airline industry worldwide, the big picture looks good. The International Civil Aviation Organization (ICAO), chartered by the United Nations, estimated that the economic impact of the global aviation industry is now $2.7 trillion, equivalent to about 3.5% of the world's GDP; in Europe it is now $860bn. ICAO forecasted that this figure should reach $5.9 trillion worldwide by 2034.

As for passenger traffic, ICAO projected that annual growth will average 3.0% through 2032, lagging all five of the other regions and the global average of 4.6%. ICAO suggested this pace is driven by "relative maturity and limited airport capacity in Western Europe".

The International Air Transport Association (IATA), the industry's largest trade organisation, forecasts that globally the airline business will earn $38.4bn in 2018, exceeding the $34.5bn earnings expected for 2017. Total passengers carried worldwide are expected to increase to 4.3 billion in 2018, up 6% from 4.1 billion this year. IATA revised its 2017 forecast upward in June 2017, and estimated the average round-trip airfare worldwide is $353.

According to IATA, European airlines are anticipated to post a net profit of $11.5bn in 2018, up from $9.8bn; IATA credits a strong economic recovery in home markets, including Russia, coupled with a rebound from terrorist threats and greater industry consolidation. IATA also stated: "An early resolution to Brexit uncertainties is needed for airlines to plan and market their flying programs."

On the cost side, increases for fuel, labour, and maintenance accelerated in 2017. IATA noted that cheaper fuel spurred an 8% drop in airline unit costs in 2016, but "that impact is coming to an end" in the 2017 earnings. Jet kerosene prices averaged $64.0/barrel.

As for traffic, in 2017, carriers in Europe posted an average passenger load factor of 84.3%, the highest rate to date. However, passenger capacity increased by 5.5%, down from an expected 6.0%. Growth in both passenger traffic (10.0% to 7.0%) and passenger capacity (6.2% to 5.5%) is expected to decrease slightly in 2018. IATA notes that among all regions in the world, break-even load factors are highest in Europe, “caused by low yields due to the competitive open aviation area, and high regulatory costs”.

Low-cost Carriers

In 2002, low-cost carriers controlled just over 9% of the European airline market. By 2017 they owned 40% of scheduled airline capacity in western Europe. The *Financial Times* described this phenomenon by stating that carriers such as Ryanair and easyJet “tear chunks out of the short-haul market”.

This growth has not only fuelled the industry by enticing more consumers to fly, but it has affected costs and fares and led to the demise of carriers unable to compete effectively. What’s more, low-cost carriers have developed ancillary revenue models that all major carriers now openly emulate.

Optional Fees

Meanwhile, the money collected by airlines via ‘optional’ fees soared once again to new heights, with baggage fees commanding the largest share at 27%. IdeaWorksCompany, a US-based marketing research firm, published its annual forecast of airline ancillary revenues in November 2017 and reported that worldwide the estimate had reached $82.2bn, or 10.6% of the industry’s global revenue of $776bn. This represented a 264% increase over 2010’s total of $22.6bn.

The annual report cited UK-based easyJet as an “ancillary revenue champ”. And it called out Irish low-cost carrier Ryanair as among “the top tier of airlines” for offering a total of 16 a la carte products.

European Tourism

In November 2017 the European Travel Commission reported continuous growth through the summer season. International tourist arrivals grew by 8% for the first eight months of the year, compared to the same time frame in 2016. In fact, 32 out of 34 countries registered increases in both arrivals and overnight stays.

In the UK, inbound tourism grew by 9% through August; factors cited included the devaluation of the pound due to Brexit. As for outbound tourism, the ETC reported that more than 75% of destinations reported “some form of growth” from the UK, noting: “A weakened pound failed to deter British holidaymakers to travel internationally.”

Insolvencies, Contraction and Consolidation

2017 saw further contraction within the European airline sector, including the shutdown of one venerable British carrier and the rebranding of another. Industry analysts pointed out these mergers, acquisitions and bankruptcies have not been as aggressive as those that have taken place in the US market; the CAPA Centre for Aviation noted: “This consolidation is an organic one, but it is a slow one.”

UK’s Monarch Airlines Shuts Down

In October 2017, Luton-based Monarch Airlines shut down 50 years after its founding and 49 years after operating its first flight. It had been the nation’s fifth largest airline and the largest to ever enter bankruptcy. Among the causes cited by analysts were devaluation of sterling due to Brexit and heightened competition from low-cost carriers.

After more than a year of rumours about ceasing operations, the end was messy; when Monarch entered administration, about 110,000 passengers were stranded abroad. This followed dramatic fare hikes and licensing woes by the Civil Aviation Authority. The shutdown affected 3,500 employees and grounded a fleet of 35 aircraft.

To accommodate the stranded passengers, the government used more than 30 aircraft to rescue them, with Transport Secretary Chris Grayling calling it the “biggest ever peacetime repatriation”. It cost £60m, paid for by the Air Travel Trust Fund.

Thomson Airways becomes TUI Airways

The UK’s third largest airline and the world’s largest charter carrier, Luton-based Thomson Airways, rebranded itself as TUI Airways in May 2017. Thomson began flying in 2008, while TUI – which rebranded five separate airlines – has origins dating back to its 1962 founding as Britannia Airways. In 2016, the airline operated more than 55,000 flights and carried 10.9 million passengers.

Meanwhile, Thomson Holidays dropped the Thomson name and rebranded as TUI UK in October 2017. (In addition to scheduled and charter airline flights, the company also offers holiday packages, hotels, resorts, and cruises.) In June 2017 TUI Group announced the purchase of 18 Boeing 737 MAX 10s, becoming the first European airline to operate the new aircraft.

IAG folds OpenSkies

In November 2017, British Airways parent company IAG announced that LEVEL, its low-cost, long-haul airline brand, would launch transatlantic flights from Paris to the United States, Canada and the Caribbean in July 2018. Concurrently, IAG’s three-class subsidiary OpenSkies – which began operations in 2008 – will cease to operate at the end of summer 2018, and staff will transition to LEVEL.

Air Berlin Shuts Down

Air Berlin filed for insolvency in August 2017 and ceased operating two months later in October. After record losses of €446m in 2015, the airline cited multiple factors, including intense competition. A year earlier, in September 2016, the company introduced a restructuring programme called the “new Air Berlin” project in conjunction with Etihad Airways, but the effort failed.

Lufthansa assumed much of Air Berlin’s operation after it shut down by buying 81 aircraft and employing 3,000 employees for €210m, while UK-based easyJet hired 1,000 employees and acquired leases on 25 aircraft for €40m.

Alitalia Files for Bankruptcy

Italy's former flag carrier filed for bankruptcy in May 2017, though Alitalia continues operating under the direction of an administrator. Despite a €7bn investment, the Italian government refused to nationalise the company, so Italian investors and Etihad (49% owners) plunged €2bn into refinancing.

Other carriers have expressed interest in acquiring Alitalia and chief among them are UK-based easyJet and Ireland-based Ryanair. The 'new' Alitalia was formed in 2008, through an acquisition and merger with former Italian airline Air One; the 'old' Alitalia brand had origins dating back to 1946.

Further Merger Rumours

Merger rumours abound throughout the European aviation market, as exemplified by the headlines made in January 2017 with talk of Lufthansa and Etihad combining.

IATA Recommends Consolidation of Low-cost Subsidiaries

In September 2017, the head of IATA suggested that the continent's major carriers should consider mergers for their low-cost subsidiaries. IATA CEO Alexandre de Juniac said the three major European networks – Air France-KLM, Deutsche Lufthansa AG, and IAG SA (parent of British Airways) – cannot compete with low-cost carriers such as Ireland's Ryanair and UK's easyJet and recommended that "a more collaborative approach may be necessary". He said the European market cannot sustain so many operators and this glut has reduced airfares and contributed to the bankruptcy filings of Air Berlin and Alitalia.

Demise of European Airline Trade Organisations

Consolidation within the European airline market claimed residual effects as well, with the shutdown of two major trade groups. In August, the European Low Fares Airline Association ceased operations after 13 years representing low-cost carriers.

This was preceded at the end of 2016 by the Association of European Airlines (AEA) closing its doors. The trade organisation, which was founded in 1952, represented 25 major air carriers. But many of its members joined a new group, Airlines for Europe (A4E), which launched in 2016 and includes British Airways parent company IAG and UK-based carriers easyJet and Jet2.com, as well as Irish carrier Ryanair.

Concerns Over Brexit

The far-reaching effects of Brexit were certainly felt in 2017 in the aviation community and not just in the UK, but also throughout the world. Among the key questions is how Britain and other nations will interact absent the comprehensive aviation treaties developed by the EU. In fact, even commercial flights between the UK and the EU itself are uncertain.

The International Air Transport Association voiced the concerns of airlines around the world when it stated: "A worst-case scenario is the UK leaving the EU's Single Aviation Market and its corresponding treaties – such as the Open Skies agreements with the US and Canada – with no replacements in place when Brexit happens, or after the expiry of any transitional periods."

Airports Council International Europe termed Brexit "so unfortunate" because it increased "prolonged uncertainty". ACI Europe President Augustin de Romanet stated: "For aviation, this means putting at risk the Single Aviation Market – the backbone upon which we provide the air connectivity that is indispensable for economic growth, cohesion, and jobs."

Indeed, US airlines – via their trade organisation Airlines for America – voiced similar concerns in September 2017: "The negotiations are moving slowly, and we are very concerned about the timing." Earlier, the concerns of British carriers were summed up in a HuffPost UK headline in January 2017: "UK Airlines 'Secretly S**tting Themselves' As EU Carriers Conspire To Exclude Them".

In late 2016, the board of the European Regions Airline Association adopted a resolution calling on EU and UK officials to:

- ensure full and open traffic rights between the EU and the UK
- allow UK-registered carriers to retain their rights under EU regulations
- create "a common European regulatory framework" by continuing to apply European Aviation Safety Agency rules and regulations to airlines and companies based in the UK

And there were additional consequences from Brexit for aviation, notably:

- the devaluation of the pound was cited as a contributing factor in the demise of Monarch Airlines
- EU passenger rights provisions may become void for flyers in the UK, as British carriers began developing contingency plans for consumer protections

Brexit looms as the most pressing issue facing the UK aviation market.

Open Skies

US Finally Approves Norwegian Expansion

After years of squabbling with US government officials through both the Obama and Trump administrations, in February 2017 Norwegian Air International finally announced transatlantic service from the UK and Ireland to the United States.

In July, the Dublin-based low-cost carrier began operating Boeing 737-800s from Edinburgh to Hartford, Connecticut and Newburgh, New York. Additional routes connect Belfast, Dublin, Shannon, and Cork, as well as Providence, Rhode Island.

The carrier announced a total of ten new routes with weekly flights, for fares as low as £69. CEO Bjorn Kjos stated the "highly anticipated" transatlantic routes were "great news" for local US, Irish, and UK economies. By December, Norwegian was operating 25 routes to US airports, including Los Angeles, with more in the pipeline: Amsterdam, Madrid and Milan.

The launch followed years of vocal and deep-pocketed lobbying against Norwegian from US major carriers and some of their labour unions. Despite such opposition, analysts are widely predicting that Norwegian may transform transatlantic pricing in the way Laker Airways did in the early 1980s.

Larger Concerns Over Protectionism

Brexit and growing concerns about US protectionism are making airline executives anxious, as they worry that Open Skies airline treaties are under threat. Aviation analyst Jeremy Robinson summed it up: "The best position is for the existing arrangements to continue and be deepened, until one day, aviation can operate as a genuinely global industry."

Others have also echoed such sentiments. In June 2017, Augustin de Romanet, president of Airports Council International Europe, warned about the larger risks of retrenchment and protectionism. He stated: "We also need Open Skies beyond the US and Canada. There is no reason not to move forward. Outbound travel from Asia Pacific, Africa, and the Middle East is set to grow exponentially in the coming decades. Europe can simply not afford to miss this next opportunity for growth."

EC Aviation Strategy

In June 2017, the European Commission announced measures to build upon the Aviation Strategy for Europe, first announced in 2015. The new steps focused on two key areas: 1) connectivity and 2) European skies.

The EC proposed new guidelines for Public Service Obligations, so that national authorities can address connectivity gaps. Furthermore, the Commission proposed to reduce fragmentation – particularly when it is caused by striking air traffic controllers in a given nation – by considering "a number of good practices to ensure air service continuity in the event of industrial action". In addition, the EC adopted new guidelines for foreign investment in airlines based in the European Union.

Reaction from the airline industry was not enthusiastic. In December 2017, the European Regions Airline Association (ERA) updated a public policy statement that called the Aviation Strategy "weak" with "no tangible remedies". The organisation asserted: "ERA believes that the Strategy will not increase the long-term competitiveness of the industry compared to other methods of transport and non-European competitors… Many of the actions proposed in the EC's Strategy are short term, have no distinct timelines for achievement and do not provide a strong and clear action plan in order to strengthen Europe's aviation industry."

Taxation

The airline industry continues to maintain that passengers and the carriers themselves pay an excess amount of taxes, despite critics who assert such claims are inflated. The International Air Transport Association stated that in 2017 the world's airlines and their customers generated $123bn in tax revenues, up from $118bn in 2016. IATA asserted this equates to 45% of the industry's Gross Value Added.

Airports Council International Europe expressed support for airport regulation that reflects "the EU's own focus on economic growth and competition". Specifically, the organisation recommended such regulation should transform from being airport-centric to consumer-centric and market-driven.

Airlines for Europe (A4E), the industry's newest trade organisation, quickly became an outspoken critic of European taxation measures. In August 2017, A4E stated: "While net airline fares decreased, airport charges and passenger taxes doubled over the past 10 years. Lower airport charges would have improved Europe's competitiveness, and potentially generated an additional 50 million passengers, which would have benefited the airports as well. In turn, that would have unlocked €50bn in EU GDP and created 238,000 jobs."

A4E concluded: "Following the abolition of all taxes in the European Economic Area, real GDP increases by 0.07% in 2018, equal to around €10.5bn. This uplift over the baseline is sustained in both relative and absolute terms over the following years, growing to 0.13% or €24.9bn per year by 2030."

Aviation Security

Europe's aviation industry expressed relief that security concerns were not as acute in 2017, in the wake of the terror attacks that rocked Brussels and Istanbul the previous year. That said, European carriers continue to believe protecting passengers should be funded by governments rather than via security taxes. For example, the European Regions Airline Association stated: "Attacks against airlines thus form part of the strategy of some terrorist campaigns against individual EU states. It therefore must be understood that the provision of anti-terrorism protection is a state responsibility and that the costs of all measures related to counter-terrorism should be borne by states through general taxation."

In September 2017, the International Civil Aviation Organization – which is chartered by the United Nations – presented its new Global Aviation Security Plan to the UN's Security Council. A key component is the Advance Passenger Information Standard, which is designed to make it more difficult for terrorists to move between member states.

Stricter Measures After 2016 Attacks

The president of Airports Council International Europe assessed the "progress achieved on landside security" in 2017. Augustin de Romanet praised smarter and non-visible steps: "These measures are doing a much better job of addressing the risk than the deployment of systematic checks at the entrance of airport facilities."

However, vulnerabilities remain, particularly in Russia. ACI Europe called it “regrettable” that new landside measures were not adopted in Russia, and stated authorities were exposing “Russian airports to security vulnerabilities which should rest with public authorities”.

Expansion of US Security Rules/Laptop Ban

In October 2017, the Trump administration imposed stricter security measures on British travellers to the United States, who number four million annually. Previously, the US had enacted a so-called “laptop ban” on large electronic devices for airlines operating out of eight nations with Muslim majority populations, but by the autumn enhanced measures were spreading worldwide, including in western Europe. All told, the new rules affected 325,000 passengers a day on 2,100 flights to the US, on 180 airlines from 280 airports in 105 countries.

The new provisions at British airports including some or all of the following for passengers:

- responding to additional questioning by airline and/or private staff
- filling out forms with personal details
- switching off electronic devices, such as phones and laptops

Carriers based in the UK and across Europe recommended that travellers budget more time when flying to the US.

Carbon Emissions Compliance

Compliance with EU Regulations at 99%

Results from the EU’s Emissions Trading System (EU ETS) indicated that overall emissions fell by about 2.7% across all industries. But compliance within the airline sector was ‘very high’, as the airlines responsible for more than 99% of aviation emissions complied with the legislation in 2016. Particularly notable was that the number of carriers based outside the European Economic Area that complied when operating within the EEA increased from 100 in 2015 to 240 in 2016.

The EU reported that on flights between airports in the EEA in 2016, verified emissions totalled 61 million tonnes of CO2, a 7.9% increase over the 57 million tonne mark posted in 2015. The European Commission proposed to continue the current approach into 2017.

Air Traffic Control Effects on Emissions

As for air traffic control, inefficiency not only affects operations and on-time performance, but it also affects the environment. The International Air Transport Association stated: “We forecast that the delays caused by inefficient airspace management in Europe alone will cost the industry over €3bn next year, as well as generating unnecessary CO2 emissions. The time passengers waste in these delays is a consumer cost worth an estimated €5.2bn.”

Virgin Reduces Emissions

In June 2017, Virgin Atlantic and Virgin Holidays published its annual sustainability report and noted aircraft CO2 emissions fell from 5.2 million tonnes in 2007 to 4.1 million tonnes in 2016. Among the key factors: a multibillion-dollar investment in Boeing 787 aircraft, single-engine taxiing, real-time weather technology that assists in route planning, and more stringent weight management on board flights.

Labour Challenges

Once again, labour issues made headlines in the airline sector in 2017. The International Air Transport Association noted “the main driver of increased costs (in 2017) is coming from labour and industry suppliers which are exerting pressure for an increased share of the airline industry’s improved financial performance. Last year, productivity gains offset wage increases, but this year we expect unit labour costs to rise by almost 3%, continuing what has already been evident in the first quarter (of 2017).”

Meanwhile, labour woes affected airline operations throughout Europe in 2017, just as they have in recent years. That said, this year’s disruptions paled beside 2016, which Airlines for Europe termed a record year for air traffic control strikes, affecting 41 total days. Foremost in 2017 were the problems affecting air traffic control in France as strikes disrupted flights, and not once but twice.

In March 2017, carriers based in the UK and Ireland – such as British Airways, easyJet, and Ryanair – were forced to disrupt operations into, out of, and through France, as more than 1,000 flights were cancelled. These events repeated themselves in October, when hundreds of flights and more than 100,000 passengers were grounded by another French controllers’ strike. Among the carriers hardest hit was Ryanair, with 222 cancelled flights affecting about 40,000 passengers.

Not surprisingly, the airline industry responded in anger. In August, Airlines for Europe quoted a 2016 PwC study that claimed ATC strikes cost the European Union’s GDP a total of €12bn over seven years, and called on national governments to “take action” over this “mess”.

Among other key events:

- In February, El Al cancelled all European flights due to a wage dispute with its pilots union. London was among the affected routes.
- A service staff strike at Finnair in March led to the cancellation of 104 flights.
- Also in March, a strike among ground workers at Berlin’s two airports led to a virtual shutdown at both facilities.
- In April, labour actions at Alitalia disrupted flight schedules.

Airline Safety

Overall, 2016 was the second safest year in commercial aviation history, with 19 fatal accidents and 325 deaths worldwide, down from 560 in 2015 and the lowest total since 265 in 2013. Aviation Safety Network's database indicates this translated into one death per 10.8 million travellers, based on 3.5 billion airline passengers worldwide in 2016.

EU Air Safety List

In 2017 there were both additions and deletions to the EU's Air Safety List, a key component of the Aviation Strategy that is overseen by the European Aviation Safety Agency. A total of 178 airlines were banned – 172 because the safety agencies in their 16 home states lacked proper oversight, and another six due to their specific commercial operations.

The EU's most recent update, in November 2017, advised that one carrier each from St Vincent and The Grenadines and Ukraine were removed from the list, while another airline from Venezuela was added. In addition, six other airlines are limited by specific aircraft types while flying within Europe.

Airlines Drop Germanwings Cockpit Safety Rule

In 2017, Germany's airlines dropped the so-called "Germanwings rule" that required the constant presence of two people in the cockpit after the intentional crash of Germanwings Flight 9525 in the French Alps in 2015. German airline organisation BDL announced that further study found the rule actually compromised safety by posing greater security risks.

Mixed Results for Safest Airline Rankings

AirlineRatings.com released the results of its annual survey of the world's safest airlines, with Australia's Qantas rated first among large carriers for the fourth year running. Two UK airlines, British Airways and Virgin Atlantic Airways, made the top 20 by the website, which ranks 425 operators worldwide based on extensive criteria, including accident and incident records.

In addition to ranking large airlines, AirlineRatings.com also published a list of the ten safest low-cost carriers. Two British airlines, Flybe and Thomas Cook, were included, along with Irish carrier Aer Lingus.

Meanwhile, the Germany-based Jet Airliner Crash Data Evaluation Centre rated 60 large carriers worldwide, with no UK carriers in the top 12. Virgin Atlantic ranked 14th; British Airways, 19th; easyJet, 28th; and Thomson, 30th. Irish low-cost carrier Ryanair ranked 34th.

Safety Over Comfort

A European Aviation Safety Agency executive said the organisation is not planning any major changes in its certification process of airline seats, as concerns grow worldwide about smaller airline seats and tighter 'pitch' (or legroom) between rows. In an interview published in August 2017, EASA Head of Communication and Quality Dominique Fouda stated: "The focus is on safety and the required evacuation of all passengers within 90 seconds. Passenger comfort is not addressed in the certification specifications."

The issue of passenger size also came to the fore in November 2017 with reports that Finnair had begun weighing passengers in an effort to better calculate aircraft take-off weights. However, the Finnish carrier asserted this was not an effort to levy additional charges for heavier passengers and an executive stated: "For us, this has nothing to do with ticket pricing or anything like that."

Outlook: 2018 and Beyond

The airline market in Europe faces several challenges in order to sustain growth and remain profitable. Chief among these is addressing the uncertainties surrounding Brexit; any transition that is less than seamless will undoubtedly have negative consequences – not only for airlines in the UK, but throughout all of Europe and other regions as well.