

## EFFECTS OF GLOBALIZATION ON EUROPEAN AIRLINE MARKETS

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*The literature this paper is based on originates from economic works that deal with competition in general and additionally with sources that show how economic methods and schemes can be used to explain the latest developments on European airline markets. In order to design this paper as up-to-date as possible, also a well-chosen variety of international journals and recognized newspapers serve as contributors to underline the stated developments.*

### Introduction

By its nature airline markets demand for a multinational method of approach. The latest discussions regarding the business model of connecting people on short and medium distances by plane derived from climate activist Greta Thunberg in 2018. Her main concerns were based on the ecological consequences of air traffic. By suggesting to rise so called airline passenger charges, like they are charged in Germany for every passenger that arrives or departs at a German airport, the amount of people that choose a plane for their travels could decrease while tax revenues rise at the same time (Enoksson, E. and Lundberg T., 2019). Beyond ecological matters the airline industry itself struggles with a significant amount of economic topics that influence its way of business. Offering less service at a lower price for tickets is the result of Low Cost Carriers (LCCs) that entered the market since the liberalization beginning in 1999. Offering basically only the seat on a plane and charging for every extra, like baggage, resulted in a partially adoption of this behavior by flag carriers as well as to a volatile number of market participants. Budd L. et al., 2013 analyzed in their study 43 LCCs that entered the European airline market from 1992-2012 and figured out that 33 of them left the market in the same timeframe again. This means that only about 23 per cent remained in business, the latest developments since 2017 regarding the resulting price war and further market exits will be presented in this paper.

Talking about the changes on the European airline market, there must be also kept close attention to effects that influence the competitive situation besides ticket prices: Or in other words, how it is possible to offer tickets for less than e.g. ten Euros. One of the reasons could be, that some regional airports that rely solely or mainly on LCCs offer huge discounts on landing fees and ground handling to the airlines they depend on. A German example would be Frankfurt-Hahn airport that is located more than a 1.5 hour drive away from the city of Frankfurt. Airlines have to determine if it is more efficient for them to send their aircrafts to primary airports, like Frankfurt/Main in order to attract also business travelers, or to start from secondary airports in order to save costs for landing fees and ground handling. One of the most striking examples for negotiating excellent conditions with secondary airports is the arrangement between Brussels-Charleroi airport in Belgium and the LCC Ryanair. The secondary Brussels airport offered a 50% discount in landing fees and a price that was fixed at one euro for ground handling (Barbot, C., 2006). Depending on the airlines choice where to start from and its bargaining power, the origin and destination of flights affect profit margins, ticket prices and competition.

Additionally to airport fees and negotiated discounts with airline manufacturers the design of working contracts with the flying personnel are crucial for the profits of airlines – especially LCCs. Like Caputo, A. et al., 2019 showed, the business model of large market participants like Ryanair is based on their bargaining power – not limited but especially between the company and its employees. For years Ryanair's pilots and stewards had Irish working contracts and the majority of the staff was self-employed. This didn't only guarantee low staff-costs for the airline but also led to huge savings regarding taxes and social welfare expenses. Like in the case of Transavia (a subsidiary of AirFrance-KLM) and since 2017 also seen with Ryanair, the rise of the bargaining power of trade unions forced airlines to cooperate and to adapt their ways of treating parts of their personnel. Also this development is likely to affect the competitive advantage of LCCs in comparison to flag carriers.

Many publications focus only on one of the listed effects on airline markets. This paper will give the reader an advanced insight in the current developments of the European airline market, taking into consideration all of the relevant aspects that influence the competitive situation.

## Market exit as a result of excessive supply

After the liberalization of the European airline market in the 1990s there was a pretty clear visible difference between flag carriers and LCCs. The latter ones operated nearly only point-to-point connections, which reduced the complexity of operating a HUB network. The services offered were charged extra, additionally to the ticket price. Besides the fact to charge for any extra, secondary airports (e.g. Frankfurt-Hahn) were favored by LCCs in order to get discounts in operating at those locations as dominant market participant. Latest since 2012 the European airline market became more and more saturated and like Budd, L. et al., 2013 pointed out there is ever since a massive market exit of carriers that favored the low cost approach. As a result of the saturation process and in order to attract more potential customers, both airline types adopted partially the business strategy of the respective other one. While it can be seen that flag carriers split up their fare classes even more (not only business and economy) by introducing so called light-tariffs they make it possible for passenger to reduce the effective travel costs for items they actually don't need (e.g. checked luggage). In contrast to this behavior LCCs extended the services the customers can choose from, while and after buying a ticket: There are also more options with different types of economy-fare classes (e.g. extra luggage, free reserved seating, complimentary meals) and additionally a large potpourri of services of which passengers can mix and match their travel experience (Ahmad, N. et al., 2018).

| Category                        | LCC                              | Flag Carrier                |
|---------------------------------|----------------------------------|-----------------------------|
| <b>Generic Strategy</b>         | Cost leadership                  | Differentiation             |
|                                 | Short-haul flights only          | Short- and long-haul        |
| <b>Product offering</b>         | No frills                        | Extended frills             |
|                                 | No services                      | Superior services           |
|                                 | Single-class, high density cabin | Multiple-class, low-density |
|                                 | Low labour costs                 | High labour costs           |
| <b>Organizational Structure</b> | Low distribution costs           | High distribution costs     |
|                                 | Fleet commonality                | Fleet diversity             |
|                                 | Use of secondary airports        | Use of major airports       |

**Tab. 1: Operational features of LCCs and flag carriers (Ahmad, N. et al., 2018)**

Ahmad, N. et al., 2018 define four degrees of differentiation between a LCC and a flag carrier (see Tab .1): The classical LCC that operates mainly according to the no-frills-model, the classical flag carrier that still offers extras that are included in the flight ticket and the so called hybrid carriers. The latter ones combine the LCC and flag carrier models but stick more to the LCC or flag carrier character. By definition LCCs seek for cost leadership, resulting in low ticket prices for customers as well as limited service. Flag carriers however operate under a differentiation strategy that should make their service superb. After all it is visible that both types of carriers adjust their services in order to become more similar to the respective other one. However it seems that despite of measures like offering light-tariffs or charging for food, LCCs adapt the high-service- approach of flag carriers to a higher extent than vice versa (e.g. offering so called „business tickets“, a ticket that includes more features than a regular LCC ticket but the customer still receives an economy seat).

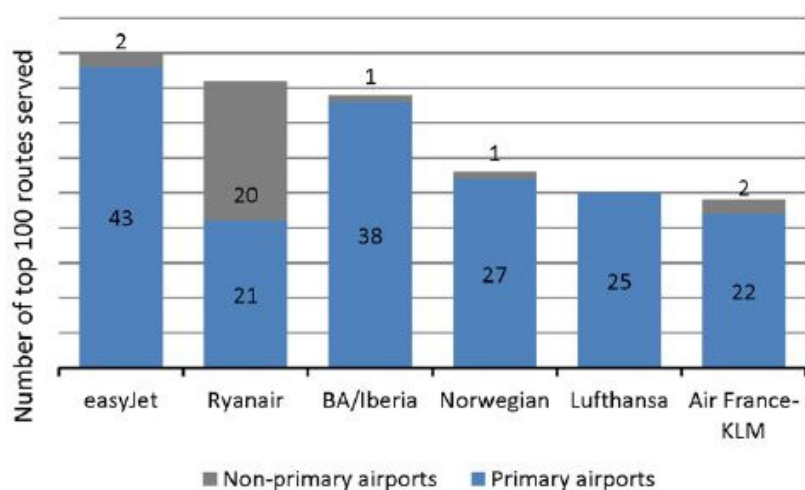
Also following the ongoing harmonization of the flight product with ever more suppliers entering the market the logical consequence was the saturation of the latter with excessive supply on most routes. From 2017 on a level was reached that made it difficult for financially weak airlines to break even. The first major airline on the European market was Air Berlin that had to suspend their service in August 2017. Air Berlin owned 144 aircraft by then, including the associated landing rights. Being out of service the market saturation should have decreased. But every single aircraft was sold by the liquidator to Air Berlins former competitors – most of them to the Lufthansa group and Ryanair. So after a short period in the beginning of 2018 – where the aircraft had to be new registered – where nearly all market participants rose their prices due to the shortage of seat capacity, the new owners of the former Air Berlin aircrafts could integrate those in their route network. This led again to falling ticket prices and due to the fact that airlines like Ryanair even bought more aircraft to support their subsidiary Niki (established to integrate Air Berlin's aircrafts into the Ryanair group), the seat capacity exceeded the values before the drop out of Air Berlin. A further decrease of ticket prices was the direct consequence (Der Tagesspiegel, 2019). Further international operating airlines couldn't cover their operating costs due to ever smaller profit margins. About one year after the capacity on the European market rose again, Flybe, a British airline, filed for bankruptcy in January 2019. Only one month later Flybmi and Germania dropped out of the market. These carriers had mainly regional destinations in Europe or operated on a charter

basis. In March 2019 the last popular airline so far wasn't able to cover its expenses anymore: Wow Air, an Iceland based carrier that offered trans-atlantic flights was forced to resign (Tsang, A., 2019).

Regarding market entry and exit, the still existing overcapacity makes it hard for airlines to operate profitable. This effects will be even intensified because the service levels of LCCs as well as flag carriers become more and more similar – leading to a kind of unified product that is available in high amounts. The resulting price drop on tickets will make it even more difficult for the remaining market participants to generate profits.

#### Choice of airports

Regarding the airport structure these can be divided into three categories: Primary, secondary and regional. While regional airports play a minor role in airline networks (they are served by LCCs and flag carriers without a typical pattern of preference due to their often remote locations), it can be stated that flag carriers focus on primary airports while LCCs also make a substantial use of secondary airports.



**Fig. 1: Favored airport type of airlines (Dziedzic, M. and Warnock-Smith, D., 2006)**

Dziedzic, M. and Warnock-Smith, D., 2006 used for their study the cumulated number of airports, the respective airlines chose for the 100 busiest routes in Europe (Fig. 1). Regarding LCCs it's clearly visible that EasyJet and Norwegian focus more on primary airports than Ryanair. The latter one seems to stick with smaller airports. One reason for favoring minor airports is that if an LCC operates out of a secondary airport, it is often the only airline (or at least there is almost no competitive situation) at this location. This leads to a monopoly-like situation with a great bargaining power on the side of the LCC which usually results in major discounts for landing fees and ground handling (Barbot, C., 2006). A further reason for sticking with secondary airports for LCCs is the availability of convenient slot times at reasonable costs. Primary airports often operate at their capacity limits, so that new market entrants can only pick unfavorable slot times for starting or landing. As a consequence of the high amount of traffic, turn-around times (the time an airport and ground handling needs from landing of an airplane until the re-start) are usually higher than at secondary airports (Dziedzic, M. and Warnock-Smith, D., 2006).

| Airport                            | Total charge at peak times (7-9 h) | Total charge at off-peak times (11-13 h) |
|------------------------------------|------------------------------------|------------------------------------------|
| <b>Munich International MUC</b>    | 7.932 EUR                          | 3.965 EUR                                |
| <b>Memmingen FMM</b>               | 1.474 EUR                          | 1.474 EUR                                |
| <b>Berlin-Schönefeld SXF</b>       | 2.135 EUR                          | 2.135 EUR                                |
| <b>Berlin-Tegel TXL</b>            | 2.705 EUR                          | 2.705 EUR                                |
| <b>Frankfurt International FRA</b> | 4.656 EUR                          | 4.656 EUR                                |
| <b>Frankfurt-Hahn HHN</b>          | 388 EUR                            | 388 EUR                                  |

**Tab. 2: Airport charges in major German markets (Dziedzic, M. and Warnock-Smith, D., 2006)**

Also since 2017 LCCs are more interested in doing business at primary airports, despite the mentioned disadvantages like unfavorable slot times and higher operating costs. The most prominent example is Ryanair that wants to attract more business travelers by hitting airports with close proximity to city centers. The data showed in Fig. 2 is based on a full rate of the ground handling price. In order to diversify the service offer, companies like Fraport (owner of Frankfurt/Main airport FRA) allowed huge discounts to Ryanair, so that the gap between the average 388 Euros at HHN (Frankfurt's secondary airport) and the 4.656 Euros at FRA melted down – to the extent the displeasure of flag carriers like Lufthansa rose at the same time. The Frankfurt-case shows that if LCCs want to attract new markets and consumer groups and primary airports are also willing to be flexible regarding the charged fees, the market situation can change pretty quickly. Offering multiple business and leisure destinations out of FRA meant for Ryanair higher turn-around times and (at least in the beginning) a smaller profit margin on the offered routes. But following the theory of Caputo, A. et al., 2019 the bargaining power of LCCs will rise the more market share they can demand for themselves. It is already visible that Ryanair expands their FRA-business as offensive as possible with an ever rising number of new routes since entering the FRA-market since 2017 (Remmert, J., 2017). At the same time Ryanair keeps ticket prices low – not at the level of comparable route-pairs formerly offered out of HHN but way lower than direct competitors on same routes out of FRA. This leads to additional seat capacity on already existing routes and as a consequence to additional competition for LCCs and flag carriers that offered the respective routes already before. Due to the intensified competition ticket prices are likely to decrease on this routes.

### Employment rights

According to Vasigh B. et al., 2013 the costs for flight personnel are the greatest direct operating costs besides the costs of fuel. They also state that the actual costs for the cabin crew expenses don't only vary by the type of airline (flag carrier or LCC) but is also highly impacted by two other circumstances:

First of all it can be seen that Southwest Airlines, a carrier that is considered to be a LCC, ranges in the middle of the spectrum of payed wages. Further investigations showed that this is a result of the extra duties the flying staff is responsible for – additionally to the common tasks of e.g. a flight attendant. Looking only on the blanc numbers it seems therefore that this LCC pays its employees higher than the competitors, in fact they are just working more effective which is the reason for this disparity. Secondly the costs for the workforce is highly driven by employees that are organized in trade unions. Findings show that most employees of the airlines are organized in trade unions which makes it hard for the carriers to adjust the wages. In general, Vasigh B. et al., 2013 see this effect for LCCs as well as for flag carriers. Of course this proposition must be outlined carefully.

Since only American carriers were part of the survey – and it is well known that the degree of the workforce that is organized in trade unions in the U.S. is severe – the European market may differ significantly. Caputo, A. et al., 2019 showed that the bargaining power of the different stakeholders in the European airline market vary, also because Europe in comparison to the U.S. is not one single state but many different countries with different laws and regulations. In countries where trade unions are traditionally well established – like France – it is more difficult for flag carriers to establish a LCC-subsidy with low personnel costs, like Air-France-KLM and Transavia. However in countries with a traditional more liberal political history – like Ireland – it is, or was a viable measure to cut costs by neglecting the intentions of the work force to organize in trade unions. Therefore the bargaining power of the employees is, or was lower compared to the employer which led in general to lower wages.

After the liberalization of the European airline market it was for a long time part of the business model of LCCs to pay wages to the personell that was way beyond industry average. The reason for doing so was the high competition they faced. In order to make profits and to raise their margins they simply had to cut operating costs. Further privatization of the airline industry, new competitors through globalization, economic downturns through recessions and raising fuel prices limited the cost drivers that could still be reduced to the workforce, like O'Sullivan, M. and Gunnigle, P., 2009 showed in their work. As a result a significant amount of the flying personnel of LCCs including pilots were hired through subcontractors by which means not only the wages could be kept low but also local taxes and expenses for social welfare could be largely waived.

Finally, similar to the U.S. status quo, also on the European airline market a change in the behavior regarding employment rights is visible – since 2017 not only by flag carriers but also e.g. by Ryanair, Europe's largest LCC. Like Southwest Airlines in the U.S. also the efficiency of Ryanair's employees is higher than the efficiency of staff of flag carriers, since the LCC's workers are covering also tasks beyond the regular obligations of the crew, e.g. cleaning the cabin (O'Sullivan, M. and Gunnigle, P., 2009). Besides of that efficiency surplus the LCC could and can also profit of the fact that less employees are organized in trade unions and Ryanair neglected for a long time to recognize employees that were willing to do so. With a significant lack of pilots in 2017 and therefore a huge number of cancelled flights the bargaining power of the workforce rose. For the first

time in its history the airline agreed that pilots organize themselves in trade unions. Only one year later also members of cabin crews in the UK could be represented by trade unions. Due to the acknowledgement of this movement by Europe's largest LCC, trade unions were able to take care of the interests and salary negotiations of their members – pilots and cabin crew – at the same time. The airline agreed to negotiate also in other EU countries with local trade unions, so that also the employees that work outside the UK could participate in this development (Topham, G., 2018).

Concluding in a wider perspective, from Europe's largest LCC to the industry, a higher ratio of employees represented by trade unions will – despite a higher efficiency of workers of LCCs compared to the ones of flag carriers – raise the cost of human resource and therefore also the price of operating cost. This circumstance is one that makes the cost structure of LCCs in Europe more similar to common flag carriers.

### Consequences and future prospects

This paper is focusing three aspects that are most influential for further competition on the European airline market: The entry/exit of market participants, the ongoing trend of airlines to focus on primary airports and the changing operating costs through increasing employment rights.

There is a significant excessive supply of seat capacity in the market that is inter alia caused by airline bankruptcies and aircrafts of these airlines that were bought by former competitors and used additionally to the existing planes. By doing so the remaining market participants had to lower the ticket prices in order to fill their aircrafts. Therefore also the profit margins declined.

Additionally to the increased seat capacity there is a high motivation for LCCs to relocate their services from secondary airports to primary ones in order to attract also business travelers. As a consequence routes that were typically offered by flag carriers have been duplicated also by LCCs. Since also the differences in the offered services between LCCs and flag carriers shrink constantly, a more and more similar product is offered in high quantity. Together with the excessive supply of seat capacity this is another huge factor that intensifies the price war between companies that have already been present in certain markets and the ones that just entered them. For covering the operating costs, the airlines have to lower the ticket prices even more, which in contrast lowers their profit margin additionally.

Finally the bargaining power and influence of trade unions rose throughout all kinds of airlines in the last years – no matter if they are classified as LCCs or flag carriers. Being organized in trade unions, the flying staff can call for better working conditions including better wages. This leads to rising costs for human resource and therefore also to rising operating costs in general. A factor that cuts profit margins of all airlines – especially the ones of LCCs.

Air traffic became more and more affordable in the last years. Ticket prices of ten Euro were not uncommon. Since the liberalization of the European airline market in the 1990s a lot of LCCs emerged and poured into the market. By 2017 the first changes of the market conditions as a consequence of saturation were visible and airlines had to declare bankruptcy. Like shown in this paper the market has still a significant amount of excessive supply with pressure on ticket prices by a high degree of competition. On the one side this factors force market participants to lower ticket prices even more in order to operate profitable. On the other side operating costs through rising costs for personnel and fuel lower the profit margin. Since all mentioned effects are likely to intensify also in the near future, one consequence seems to be obvious: Market exit of airlines that cannot stand the rising competition and the higher operating costs, in accordance with higher wages for flying personnel, and finally rising ticket prices on consolidated routes.

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### Summary

In „Effects of Globalization on European Airline Markets” Markus Engert M.Sc. and Prof. Dr. Rainer Wehner give a closer insight to current challenges of the European airline industry. For years the optimization of the price-performance ratios led to a significant decrease of service as well as ticket prices. Since 2017 the short-term consequences of this corporate strategies are clearly visible: Market exit, change of preferred airports and changing operating costs through increasing employment right.