Updated overview of the Aviation sector

By Steven Thompson QC, XXIV Old Buildings

Turbulence in the aviation sector

It is no secret that the aviation industry is under financial pressure. At the end of 2017 Monarch Airlines collapsed, followed by VLM, Primera, Cobalt Air, Flybe, WOW. Last year Thomas Cook fell and this year has seen the last gasp of Flybe. Now the coronavirus pandemic is again putting airlines, and hundreds of their suppliers, under severe pressure. That will cause an immediate worry for employees being furloughed, asked to take unpaid leave and made redundant – thousands of jobs have already been shed by airlines and their suppliers.

To compound that, there is a real risk of a deep recession following the emergency economic measures being taken now by governments and a further risk that the public will just be too fearful or cash-strapped to want to fly even when restrictions are lifted. Many airlines simply cannot afford to fly with middle seats empty, at least not without pushing the price of tickets to a level not seen for decades. Whilst passengers remain nervous of catching Covid-19, they will be reluctant to fly even without price hikes.

From the start of the year, the global aviation market has been fearful. Today it has shrunk to a level unimaginable in recent times after government after government locked down their countries, leaving would-be holiday-makers prohibited from leaving home and business travellers with all their plans cancelled.

Most airports remained open but only for cargo and to facilitate repatriation of those found abroad. Although the price of oil dropped dramatically, turning negative for a few days in some markets, many airlines are carrying impossibly heavy debt burdens. Most airlines in Europe and North America were not in 2019 regularly generating enough cash to make any significant profit after servicing their debt obligations, and that was a good year compared to others this millennium.

This article, which avoids the word “unprecedented”, contains a recent history of the sector, attempts an overview of the state of the airline industry today and makes some predictions about the future. It considers how airlines might weather the storm, managing first their fleets and then their recoveries.

Thomas Cook

Despite raising £900m just a month earlier, on 23 September 2019 Thomas Cook went into liquidation. Thomas Cook was a diverse group of travel companies which had a significant high street presence, a legacy from its history as a travel agency, as well as some 100 aircraft. The Official Receiver estimated it to have liabilities of £3.3bn excluding inter-company debt. The directors later attributed the group’s insolvency to a number of factors including uncertainty over Brexit, the hot summer of 2018 in the

UK and the challenges from low-cost airlines. However evidence given to a House of Commons select committee suggested that it was struggling under the burden of debt which cost it in the region of £150m per year to service. It was that underlying financial problem which made the company susceptible to the events which caused its demise.

Grant Shapps, the Travel Minister said at the time:

> *"Look, the government is not in the business of running travel operators…If we did try to step in, it would only have been a few weeks away from having to do exactly this anyway. In the end, the private investors, the bondholders, all the rest of them, couldn't come together with a deal. That's why we took the decision."*

Andrea Leadsom, the then Business Secretary said in the House of Commons:

> *"Why did we not bail out Thomas Cook? Simply because it was clear that the £200 million it was asking for was just a drop in the ocean. There was no way the company could realistically be restored, despite the Government seriously considering the prospects for doing so and for making it an ongoing concern."*

The collapse left more than 140,000 holiday makers stranded abroad, mostly in Turkey, Spain and Greece. They were repatriated thanks to the efforts of the Civil Aviation Authority (CAA) and regardless of whether the customers had booked 'ATOL' protected holidays. That decision taken by the Secretary of State for Transport is ultimately likely to cost the UK Government some £83m. That compares to the figure of £45m for the repatriation of customers after the collapse of Monarch, of which only £2.3m was recovered.

Thomas Cook had been monitored by the CAA for some time before its collapse. HM Government said that it and the CAA had used their experience of the Monarch repatriation and the recommendations of the Airline Insolvency Review (which had been published in March 2019 – as to which, see below) to plan for the collapse of Thomas Cook.

Flybe

In January 2020 Flybe was bailed out by the state. The Business Secretary Andrew Leadsom said:

> *"The government isn't in the market to bail out private companies. What we do on a case to case basis is look to see if a business is viable. In the case of Flybe, it is a viable business."*
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> *"The difference, for example, between Flybe and Thomas Cook was that in the case of Thomas Cook it had huge amounts of debt and any taxpayers money would have simply been throwing good money after bad. It was not a viable company."*

At that time, British Airways, Ryanair and easyjet were vociferous in their condemnation of the bail out. Michael O'Leary, Ryanair's chief executive said:

> *"This government bailout of billionaire-owned Flybe is in breach of both competition and state aid laws. The Flybe model is not viable which is why its billionaire owners are looking for a state subsidy for their failed*

> *investment"*. He added *"If Flybe fails, as it undoubtedly will once this government subsidy ends, then Ryanair, easyJet, BA and others will step in and provide lower fare flights from the UK regional airports, as we already have to make up for the recent failure of Thomas Cook Airways."*

As Mr O'Leary predicted, on 5 March 2020, less than 2 months later, Flybe went into administration. Kelly Tolhurst MP, the Parliamentary Under-Secretary at the Department for Transport, said: *"Unfortunately, in a competitive market, companies do fail, and it is not the role of government to prop them up."*

The position today

The pandemic coronavirus outbreak is putting the aviation industry in general and airlines in particular under even extreme pressure. Unlike some other sectors, it has no hope of bouncing back. Airlines, manufacturers and airports have all been vocal in seeking state support to help them through; early reports suggested that HM Government might nationalise some airlines, as other European governments have. In the US, the CARES Act passed on 25 March 2020 earmarked $61bn for the aviation industry.

But in the UK the Chancellor of the Exchequer quickly dampened airlines' hopes of a bail out. Airports were disappointed; by the end of March some had shut altogether and even the busiest of them were operating at a fraction of their capacity. By the middle of April, every country in Africa, Asia and the Pacific and the Middle East and over 90% of those in Europe and the Americas had shut their borders to some or all visitors, suspended most or all incoming flights or instituted severe quarantine, visa or medical certificate restrictions designed to stop the virus travelling internationally. Air travel collapsed.

All major airlines drastically reduced their passenger operations, some suspending all flights. Eurocontrol, which monitors European flights reported a steady daily drop in flights over Europe starting in early March. By 29 March 2020 there were 24,000 fewer flights on than the equivalent Sunday in 2019, down 88%. In each week in April there have been between 86% and 92% fewer flights than the same week in 2019. DHL has been left as the busiest operator in Europe. The busiest passenger airline in April has been Widerøe, a small regional Norwegian operator flying largely within that large, thinly-populated country. So far this year there have been over 1,000,000 fewer flights in Europe than there had been by this time last year.

There are now difficult decisions for airlines to make balancing paying out refunds to customers and preserving cash. Many are already getting bad publicity for delaying repayments, offering vouchers for re-booking or just making claiming them cumbersome – whilst offering excuses with various degrees of credibility. Some estimates put a value of £7bn on the cash which the airlines should be, but are not, refunding. In the EU this is simply a breach of contract with the disappointed passengers – payments out are required by law within a fortnight.

Canada has already permitted airlines to offer vouchers rather than refunds. UK airlines have eyed that change enviously. Airlines UK, which represents British Airways, easyJet, Jet2, TUI Airways and Virgin Atlantic, and the Association of British Travel Agents ('ABTA') have both lobbied HM Government to relax the rules to allow longer for refunds. And a dozen EU governments have lobbied Brussels to change the law to permit airline to offer vouchers. There is now a real concern for the future of some major airlines – which should make customers less keen on accepting vouchers in lieu of the cash to which they are entitled. The reality is that many airlines cannot afford to refund the tickets and stay solvent.

The UK has relatively healthy airlines compared to all other European and most other countries. But they are facing the fact that other governments are bailing out their airlines with abandon: Air France has been given a €7bn loan / loan guarantee bail out by the French government and the Lufthansa group is reportedly seeking €11.5bn in support. Ironically the good financial position of BA, easyjet and Ryanair (which is Irish but heavily dependent on the UK market) mean they are receiving less sympathy and support. Virgin Atlantic, which is weaker as an airline, suffers from having a high-profile, controversial figurehead who elicits little sympathy from the public.

There is one piece of good news for the sector – air cargo is flying at broadly the same levels as before the pandemic, and, based on China's gradual recovery, could remain healthy.

Storage and parking up

The crisis will result in some airlines bringing forward their plans to retire the less profitable, ageing aircraft in their fleets, notable some Airbus 380s, Boeing 747s and 777s not to mention the few remaining Boeing 767s and MD90s still in commercial operation in North America. But most will have to stored.

Aircraft like to fly. But they can be parked up for long periods of time as long as the appropriate maintenance procedures are applied. They are resilient enough to be left outside a hangar in all weathers as long as they are closed up. US Operators have long used the desert states to park up aircraft, and indeed many have had some recent experience because of the grounding of the Boeing 737 Max fleet, which was some 500 strong. As long as the apertures, engines, pitons, windows and doors are adequately protected from the sun, wind, sand, insects and birds, aircraft can be stored pretty much indefinitely, albeit at a cost. In western Europe the risk from rain and dampness is more serious than from sand so preservation measures will have to be adjusted to reduce the risk of corrosion. In the UK, Kemble Cotswold airport in Gloucestershire has long been used to park aircraft as have Teruel in Spain and Tarbes in France.

But given that the airports are also now quiet, many operators have taken to storing their grounded fleets at the airports, even on unused runways – from Copenhagen to Dehli, from Frankfurt to Tulsa. In the UK, Glasgow and Bournemouth are the parking airports of choice for British Airways. Lufthansa is using Berlin Brandenburg airport which is yet to open. Emirates, which is owned by the government of Dubai, is lucky that its home airport is large, dry and essentially free for it to use – also being owned by the government of Dubai. As a hub, the closure of Dubai International Airport is another blow to any airline which used it as a stopover for flights between Europe and SE Asia and Australasia – notably Qantas.

Airlines can usually estimate in advance how long they might want to store an aircraft or a fleet. All manufacturers and operators have short-term, medium-term and long-term storage maintenance programmes. In the case of the B737 Max parking up, the term was of course unknown and remains indefinite. With the current pandemic, it is similarly unknown but it would be a fair guess to imagine that a lot of aircraft for a lot of airlines will be parked up for 3 to 6 months. It will take about 80 hours of maintenance to put aircraft and, importantly, engines into an appropriate state for storage.

Then they will need to be checked periodically, so that bacteria do not proliferate in fuel tanks. Engines, auxiliary power units (APUs) and flight computers need to be started up from time to time to ensure they are working and because, like all machinery, they benefit from usage. Operational checks of the hydraulics, avionics, electrical systems and landing gear will have to be done. Other moving parts like the flaps and flight-control surfaces need extending, retracting and lubricating. Aircraft have to be moved to avoid wear on just one part of tyres. In wetter environments such as in western Europe, the interiors will need to be checked for water ingress, dampness or mould.

On return from storage, each aircraft might need another 100-150 hours of maintenance, which will include an audit to put the aircraft back into the regular maintenance programme, as well as other tests on the systems which will have been in hibernation. And they will need to be cleaned, inside and out.

What is going to happen?

Virgin Australia went into administration on 21 April with debts of A$7bn. It could be bought and rescued, but it will not be the last airline to fail. Some will be bailed out with grants, loans or partial nationalisation, just as happened in 2008 with the Royal Bank of Scotland. Others will of course survive and thrive in the less crowded market.

In Europe the picture is complicated by the fact that many airlines are partly or wholly state-owned and there is national pride behind some flag-carriers. Ryanair was the continent's biggest carrier and it has been vocal about the bail-out being sought and offered to its weaker rivals, many of whom as state-backed anyway.

In the US, the airline industry serves a vital domestic transport service, which it claims entitles it to state support. And domestic travellers do not face the same risk of being quarantined or denied entry on arrival. Of course US airlines have a long history of operating under the protection of Chapter 11 bankruptcy rules.

On 24 March, International Air Transport Association (IATA) updated its analysis of the impact of the pandemic on the aviation industry, and now estimates revenues will fall away by $252bn, which would be down 44% on 2019. That estimate is based on severe travel restrictions for 3 months, followed by a gradual economic recovery later in the year. Even based on what is looking like an optimistic assumption, that predicted fall in revenue is more than twice as much as IATA had estimated less than 3 weeks earlier, at a time when few countries had introduced sweeping travel restrictions. IATA's CEO said *"Without immediate government relief measures, there will not be an industry left standing. Airlines need $200 billion in liquidity support simply to make it through."* IATA's analysis suggests that the biggest percentage drop for the industry will be in Europe.

IATA also commented upon airlines' cash reserves, reporting that the median airline had 2 months of cash at the start of 2020. Outside the biggest 30 global airlines, the level of debt is worryingly high. *"Only 30 airlines drove the improvement in profitability that we saw in the last 10 years"* Brian Pearce, chief economist at IATA was reported as saying. He continued *"Obviously, there are a number of airlines that are in a much stronger position to weather this lack of revenues but the majority are in a very fragile place."*

Easyjet issued a statement to the stock market which said:

> *"European aviation faces a precarious future and there is no guarantee that the European airlines, along with all the benefits it brings for people, the economy and business, will survive what could be a long-term travel freeze and the risks of a slow recovery. Whether it does or not will depend significantly on European airlines maintaining access to liquidity, including that enabled by governments across Europe."*

Industry analysts report that, of European airlines, Wizz and Ryanair are looking relatively safe with high levels of liquidity but that Norwegian, SAS and Lufthansa at the more worrying end of the spectrum.

In March the UK Government announced, and has since introduced and extended until the end of June, a scheme to assist employees to ameliorate the financial burden upon them and, indirectly, upon airlines and other employers. Fuel costs are not an issue: the planes are not flying and anyway the fuel price had plummeted. The attitude of banks and aircraft lessors is harder to gauge but it is a fair guess that they will be sympathetic partly out of altruism (they are, truly, all in this together) but also as there is no alternative revenue stream. The terms of the leases and agreements will usually be strict and in favour of the lessors and lenders, but one can imagine rent and finance holidays being offered soon, albeit quietly and behind the scenes. The signs from the US is that airlines can still access capital in the market.

The Airports Council International (ACI), a non-profit body which represents the airport industry, estimates that around the world airports will suffer a drop in revenue of $46bn. Airports of course will suffer indirectly from airlines in distress. ACI identifies the risks including flights cancellations, aircraft groundings, travel bans and border closures resulting in fewer flights with lower load factors. They are also worrying that they will suffer from higher cleaning costs.

Debates are ongoing about physical distancing, masks and face coverings on flights, about tests before boarding and screening on arrival. Boarding and airport processes will have to change to accommodate the new normal. The aviation industry is particularly fearful of quarantine restrictions. If all incoming passengers are required to stay indoors for 14 days upon arrival, few visitors will wish to come and not many locals will want to go away only to be locked down when they return home. Many airports see screening as a solution to enable reopening of borders. The chief executive of Heathrow has called for common biosecurity standard for air travel so that passengers can have confidence that their destinations are kept safe, and countries can have confidence that visitors are not infected upon arrival. This would push up the time it takes to get through the airport, just as the security checks introduced in the last 30 years have.

The scale of the recession which is likely to flow from the emergency measures being put in place to prop up national economies will compound the problems faced by the airline industry. It is quite impossible for passengers on today's commercial aircraft to stay 2m apart unless they are operating almost empty – which would only be economically viable for airlines if airfares rocketed. For years, increasing the load factor has been the holy grail for airlines and now they are facing mandatory reductions of the factor to 67% or less. Even diluted physical distancing rules would still likely mean the end of the low cost flying which we have enjoyed for a generation. The public will remain fearful of flying. Surveys should be taken with a pinch of salt as the picture changes weekly but a recent survey conducted by IATA suggests that some 30% of the public would wait at least 6 months before flying again. People who steer a wide berth round a stranger in the supermarket to avoid a few seconds of proximity will not any time soon risk sitting squeezed in the middle seat in a Boeing 737 for an hour or two. Airports have pointed out that their business model is predicated on herding passengers.

All this is going to be tough, but the world will need to continue flying after this crisis, even if it takes years to get back to 2019 level. We are all learning to use technology to work remotely, and environmental awareness is growing, pushing for green commitments from anyone seeking a publicly-funded bail-out. But the world is too interconnected to go back to the era before flying. The industry will recover, changed no doubt, and maybe for the better. As Alexandre de Juniac, IATA's Director-General & CEO puts it *"Stay strong. We will get through this crisis and keep the world connected".*