PILARSKI SAYS

What evolution can tell us about future of airline profitability

The relationship between oil price and the profitability of carriers is a complex one, writes Adam Pilarksi, senior vice-president at Avitas.

Some readers were dismayed by my May column in which I expressed doubts that airlines from now on will be profitable forever, as some highly respected industry leaders claim.

My belief is that the industry cannot change its stripes and eventually will revert to its old sinful ways. This does not mean that the airline industry cannot be profitable in the long run, but rather, that the present glorious situation is because of specific circumstances and behaviour changed, reflecting those new circumstances.

Evolutionary biology teaches us how humans adapt to changing circumstances. These changes have tremendous implications on many aspects of our personal lives, such as mate selection or procreation. But those principles can also be detected in how countries, industries and firms change behaviour in order to survive.

Many years ago, I did some research on how people's productivity changes as they have more children. This was first examined by Soviet economist AV Chayanov in 1925. He found that peasants who had more children worked much harder and produced more. A simplistic a priori belief that peasants with more children had to be poorer turned out to be false because of evolutionary change in behaviour as a result of having extra children.

So how come airlines are finally profitable now? Exogenous events are part of the reason, the major one being the dramatic drop in oil prices. Another is a definite change in behaviour towards more rational pricing, cost control and capacity discipline. And part of it, in the USA at least, is the diminished competition that allows above competition-determined prices.

Historically, analysts were getting the relationship between oil prices and airline profitability totally wrong. They assumed that higher oil prices would lead to lower profits because of operating costs going up. In reality, such a relationship is more complicated and empirical evidence did not support such a simplistic assertion.

Higher oil prices led to changed airline behaviour manifested mainly in higher ticket prices which, in turn, reduced traffic but often increased total revenue. While analysts seemed to miss that point, airlines were well aware of such a reality. So why did they not increase ticket prices when oil was cheap and priced their product unwisely leading to years of losses?

The answer is of course competition. If they increased prices and their competitors did not, they would lose market share. This unwise fight for market share led to decades of bad profit performance of the airline industry, which seemed to have been caught in a Greek tragedy-type situation. When things were good (low oil prices), the airlines did not behave in a rational manner, entered market share wars, underpriced their product and lost copious amounts of money. When things were bad (high oil prices), airlines had to change their behaviour in order to survive. Evolution triumphed and rational pricing was adopted.

How come the level of oil prices is such a differentiator of behaviour? With low oil prices, labour was for decades the major component of airline costs. The difference, though, is that airlines felt more confident in being able to control labour than fuel costs.

Labour agreements are negotiated in person and have a large emotional component, so some may believe they are more difficult to predict. In fact, labour can be rational under certain circumstances and has sometimes been quite flexible to adjust behaviour to fit circumstances. The same is true on the irrational side. Labour can take offence at perceived injustice and lead to destructive and irrational behaviour that can sink airlines. Labour negotiations use game theory and, as such, sometimes lead to disaster but they are under control of the two relevant parties.

Airlines have absolutely no control over oil prices. Our industry accounts for a small sliver of the total oil consumption worldwide and prices are a given reality the same way the weather is. Airlines recognise that high oil prices, when they happen, are a fact of life, and the only way to handle them is to evolve towards rational behaviour and change pricing. High labour costs, the airlines believe, are something they can successfully combat – hence, they do not need to adapt and change their pricing policies.

Right now, we are beginning to see a change in labour relations in Europe with strikes in France, the UK, Scandinavia and Greece. This may be the beginning of lower profits for airlines in the coming few years. Not necessarily losses but the continuation of current high profitability is unlikely to continue forever.