The Canadian Air Industry and the Case of Porter Airlines

Mary-Jane Bennett
Executive Summary

There have been big changes in the Canadian aviation sector. Porter Airlines, having launched in 2006, announced an ambitious expansion last month. WestJet, built on the Southwest Airlines low-cost model and now in the international market, announced the summer debut of its subsidiary, Encore. Legacy carrier Air Canada, having recently undergone a joint venture merger with one of its Star Alliance partners, also intends to inaugurate its new subsidiary, Rouge, this summer.

This recent turbulence in the skies is not restricted to Canada. Around the world, the airline industry is in a state of flux. The changes are driven by the wide cost advantage that a low-cost carrier (LCC) maintains over a legacy carrier such as Air Canada. This advantage gives many of the LCCs, including WestJet and Porter, the flexibility to move into the traditional business of the legacy carrier. Challenged by the rise of the LCCs, the legacy carriers have responded with a change in their business model, all but abandoning their signature luxury in-flight services. The result is that the old categories of legacy and low cost are increasingly blurred.

For the airline passenger, price remains a key concern on short-haul flights, but convenience of schedules, airport location and service still count.
Background and the case of Porter Airlines

In 2006, Porter Airlines entered into this newly clouded paradigm. Last month, it announced a planned expansion: six more Q400 planes and 30 new CS100 whisper jets to serve 14 new cities including Las Vegas, Los Angeles and San Francisco. Porter Airlines maintains its base at the Billy Bishop Toronto City Airport (BBTCA), owned by the City of Toronto and leased to the Toronto Port Authority. A 1983 agreement, known colloquially as the Tripartite Agreement, governs the BBTCA. Before Porter Airlines can expand, the agreement requires amendment to address jet service and runway extension.

This paper avoids the question of the jet ban and the runway extension. Rather, the proposed expansion of Porter Airlines represents an opportune time to examine the airline industry. With Canada now served by three major scheduled airlines, the paper examines the challenges facing the carriers and lists the various benefits of airline competition.

The paper also looks at the predatory behaviour that Porter Airlines alleged it would face as a new entrant. Specifically, the paper looks at the allegation that through a dramatic and short-term increase in low fares or added capacity, an established carrier may eliminate new entrant airlines. Porter Airlines addressed this concern at the outset, raising it early in its discussions with the Toronto Port Authority.

To provide context to these questions, some background on the Porter Airlines hub at the BBTCA is necessary.

Source: http://torontoist.com/2013/04/porter-announces-major-expansion-proposal/
Tenancy at the Billy Bishop Toronto City Airport

With its seaplane base, paved runway and clapboard terminal building completed by 1939, the then Port George VI Island Airport was initially used for private charters and hobby flying. Its transformation into a bustling international airport was years in the making.

In 1983, the airport’s owner, the City of Toronto, granted a 50-year lease to the Toronto Harbour Commissioners (later the Toronto Port Authority). City Express, an Ontario short-haul airline, began operating flights from the airport. In 1990, Air Canada subsidiary, Air Ontario and thereafter, Jazz Air set up operations at the airport. By 1991, City Express ceased operating and Air Ontario had few flights leaving from the airport. The airport was operating at a loss while the Air Canada affiliates were there, and by 2002, even that operation had diminished.

During 2002, the Toronto Port Authority renewed its request to Air Canada’s Jazz to enhance operations from the airport, and it began a search for a new tenant. In September of that year, it entered into a memorandum of understanding with Porter Airlines. Although interested, Porter expressed concern over possible anti-competitive behaviour by Air Canada unless provided an almost exclusive right to use the runway at the airport. Specifically, Porter Airlines required 143 of the 167 available landing and take-off slots in order to ramp up operations.

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The Toronto Port Authority asked the federal Competition Bureau to review the Porter request. Specifically, it wanted to know whether granting Porter an almost exclusive position at the airport interfered with competition law.

The Competition Bureau’s 2002 response found that with the Toronto region served by Pearson International Airport and the nearby airports in Markham and Hamilton, there was no lack of competition in the Toronto area. With Air Canada the dominant player both in the region and at airports across Canada, granting the majority of slots to another player was not problematic. The Competition Bureau concluded that capping Air Canada’s take-off and landing slots was justified as an interim measure to allow Porter Airlines to establish itself.

By 2004, Air Canada’s Jazz had reduced the number of flights it was operating from the airport. After its lease expired in November 2004, Jazz continued its leasing agreement on a month-to-month basis. By 2005, it had terminated its shuttle bus service to the ferry and was using only six of the airport’s take-off and landing slots. In 2006, Jazz received notice of lease termination and ceased operations.

In February 2006, Porter began flying from the airport. The Toronto Port Authority granted its initial slot guarantee on a use-it-or-lose-it basis. After Porter’s launch, Jazz announced that it wished to re-launch and initiated a series of legal claims alleging restraint of trade and bad faith by the Toronto Port Authority. The claims were later withdrawn or dismissed.

By 2008, the airport, which had previously operated at a loss, generated a profit.

When Porter announced last month that it intended to expand service, WestJet and Air Canada indicated a desire to launch services from the BBTCA.
Allegation of predatory practice

Porter Airlines argued that Air Canada and its affiliates, with their operating preference for Pearson International Airport, had allowed the island airport to deteriorate. Only when Porter, after assuming all the risk, had made the airport viable did Air Canada wish to return. If Air Canada were allowed a greater presence at the airport, Porter Airlines feared that it would be subject to predatory practice.

Specifically, the practice that Porter Airlines sought to avoid is that of swamping routes with flights and low fares on a short-term basis in order to eliminate competition. It is a practice with deep roots in the industry.

Michael E. Levine, former executive vice-president of Northwest Airlines and current distinguished research scholar at New York University’s Faculty of Law, provided a how-to on predatory airline practice in a 1987 article in the *Yale Journal on Regulation*:

The essence of the strategy is simple. Match, or better yet beat, the new entrant’s lowest fare with a low fare restricted to confine its attractiveness to the leisure-oriented, price sensitive sector of the market. Match business and frequent fliers. Add frequency where possible to “sandwich” the new entrant’s departures between one’s own departures. Make sure enough seats are available on your flights in the market to accommodate increases in traffic caused by the fare war. In short, leave no traveler with either a price or schedule incentive to fly the new entrant. If the new entrant attempts to lower prices ... the incumbent matches, no matter how low the fare. The object is to reduce trial and to subject the new entrant to a prolonged period of operation at low load factors. The strategy saps the entrant’s working capital while inhibiting trials that would disseminate favourable information about the new entrant.

One high-ranking associate at American Airlines confessed that this type of market abuse against new entrants should not be considered “good spirited competition.” Porter Airlines sought to avoid any consideration of this practice.
Both the legacy and the low-cost carrier face challenges

The domestic airline market of a country is divided into two large groups, the legacy carrier and the low-cost carrier (LCC). Air Canada, which has a 76-year history, is Canada’s legacy carrier.

Low-cost carriers such as Texas’ Southwest Airlines, which launched across the United States after the 1978 deregulation of the industry, are relatively recent innovations in the airline world.

WestJet, modelled on Southwest’s no-frills, point-to-point, quick return, one-fleet model, is Canada’s pre-eminent LCC. Porter Airlines, Canada’s newest entrant in this category, has steadily increased its presence since its 2006 launch.

Traditionally, the legacy carrier generates a profit from the less competitive long-haul international routes. This means suffering a loss to cross-subsidize short-haul services, a Winnipeg to Calgary flight, for example.

The legacy carrier faces a number of hurdles. Unlike the LCC with its traditional single-fleet model, the legacy carrier has a varied fleet. This limits savings in maintenance and training. The legacy carriers have a higher level of unionized labour and lower labour productivity. The legacy carrier’s hub-and-spoke business model requires it to cater to business and economy class all the while juggling short-haul and long haul passenger loads. This remains an ever-present challenge.

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Fluctuating fuel prices hit the legacy carrier harder, especially a carrier such as Air Canada with its short-haul fleet of older and thirstier planes. The legacy carrier, due to its international routing, remains vulnerable to unanticipated taxes imposed by some countries, such as the United Kingdom and Germany. New taxes are as great a danger as uncertainty in fuel prices. New competition, trends and routing on international routes add to the legacy carrier’s challenges.

Described as having “thrived in the good times and haemorrhaged in the bad,” the legacy carriers have had a rocky ride. Between 2000 and 2003, the legacy airlines in the United States incurred nearly $25-billion in operating losses while the LCCs gained $1.3-billion in profit.

The legacy carriers were in similar straits in Canada. By 2000, legacy carrier Canadian Airlines had become a wholly owned subsidiary of Air Canada. However, saddled with $13-billion in debt and losing
The global financial crisis focussed the minds of the legacy carriers. That focus led to the disappearance of their traditional perks.

In 2006 and 2007, 10 of the world’s largest legacy carriers were profitable. The number dropped in 2008. Seven of the legacy group lost money that year, and by 2009, eight were in the red. By contrast, of the top 10 LCCs, only three lost money in 2008 and two in 2009. Although profits have been at lower levels than those of the legacy carriers, the LCC advantage is that it remains consistently profitable.

A recent report by KPMG, a global consultancy, found that despite the intensive focus on costs, legacy carriers were only able to trim approximately one-third of their expenses. KPMG termed the remainder structural. The legacy carriers are still spending 2.5 cents more per kilometre than their low-cost rivals are. To provide context, this translates, says one review, to a legacy airline that is operating an Airbus A320 between London and Rome spending $12,000 more on each round trip than its low-cost rival does.

The LCC, with service usually confined to short-haul routes, maintains an impressive 30 per cent cost advantage over the legacy carrier. In Europe, this cost advantage is between 30 per cent and 60 per cent.

This gap in expenses generated changes in the industry. Some LCCs moved up the chain, adding business class and international flights while some legacy carriers took on the characteristics of their non-premium LCC counterparts. The differences between the legacy carriers and the LCCs began to blur. Today, the airline world is in a state of flux.

The ascent of the LCC does not mean it has avoided growth problems. Raised on a “diet of double-digit growth,” the LCCs’ challenge is to find new routes and new markets. Global consultancy firm Oliver Wyman claims that with the high levels of penetration that the LCCs now enjoy, growth is a pressing issue. “… Where do you go? You find more segments [of the market] or you fly further.”

Many LCCs are finding new markets and many are flying farther. Southwest Airlines and JetBlue now fly transcontinental routes. In Canada, WestJet, which covers both markets, announced new domestic routes including Fort St. John and Fort McMurray, along with international routes. Porter Airlines also targeted new markets with an ambitious plan. The key question remains whether the LCC can fly farther without incurring new costs.

Some LCCs maintain that they can add new routes without adding costs. They rely on ancillary revenue to overcome the new bottom line. For them, the ancillary revenue of seat selection, extra legroom seating, reservation change fee and checked-in baggage fees must remain a staple. Not only are ancillary charges a revenue generator, but some fees, assigned seating for example, lead to growth into business class.

Ancillary charges are important claims former Ryanair commercial director Tim Jeans. “‘When you get €6 ($9) just by selecting a seat, even if only half [the passengers] do it, that is a massive amount of money flying straight to your bottom line.’” The amount of money in ancillary charges is massive indeed, bringing in a new-found revenue stream for the industry of about $36-billion worldwide in 2012. Although ancillary fees have increased by about 11 per cent internationally, at 5 per cent in North America, they have been more constrained.

When Spirit Airlines, for example, nickel-and-dimes an average $103 per round trip in ancillary charges from passengers, the lure of this relatively new revenue stream is hard to resist. The traditional holdout for non add-on travel, Southwest Airlines, appears on the verge of re-consideration of the add-on advantage. Its former claim that new ridership and passenger loyalty are won with a no add-on travel experience has been revisited and replaced with a no-show ticket fee and a premium boarding fee. Its trademark “Bags Fly Free” slogan, briefly dropped from its advertising, is back.
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Although ancillary charges are not restricted to the LCCs—legacy carriers are in fact leaders in this category—the added ancillary charges revenue allows the LCCs clear room for growth.

Deterrents to the smooth growth of the LCCs include the cost of entering into the co-operative arrangements necessary to create international networks and selling through global distribution systems. The central plank of the LCC, the single-fleet model, has its advantages and disadvantages. Although the single-fleet model is less complicated than a two-fleet model, it limits growth. The LCCs that choose to fly farther will have to jettison this model. Yet, fleet growth comes with its own set of challenges says Rigas Doganis, aviation expert and former Olympic Airways chair. “You have to be a big operator if you’re going to have a two-fleet, as you need to bring in 30 aircraft, not just two or three,” he cautioned.

For the LCCs, the Catch-22 is that if they stop growing, their costs will increase naturally as staff gains seniority. Growth is essential, and for some LCCs, that growth includes the consideration of mergers and alliances.

The difference between the two groups is network structure. While the legacy carrier with its international routes moves passengers through hub networks, LCCs prefer a point-to-point service, often avoiding the denser airports and attracting a large new base of passengers. This has benefitted the LCC in a number of ways; including reduced landing fees, passenger preference for point-to-point service and quicker airline turnaround at secondary airports. Yet, the legacy carrier’s hub-and-spoke network provides a competitive advantage over the LCCs on international routes.
Growth challenges for the legacy carrier

For the LCC, growth has meant moving into the traditional zone of the legacy carrier. But how does the legacy carrier grow?

The problem for the legacy carrier is that the antiquated bilateral treaties on flying rights between countries and the restrictions on foreign ownership stall its growth. Although the airline industry has responded to the restrictions through various inventive strategies, these strategies have been cumbersome and have not allowed the full growth that the legacy carrier requires.

To grow, the legacy carrier has available to it two courses of action. Either it can create a subsidiary airline or it can merge.

The legacy carrier and the subsidiary airline option

On December 13, 2012, Air Canada announced the launch of its new leisure subsidiary airline, Rouge, set to take to the skies in July of 2013. Rouge intends to serve a variety of holiday destinations including Venice, Athens and Edinburgh in Europe and various sun destinations in Mexico, South America and the Caribbean.

Subsidiary airlines have two functions: They tackle competition from LCCs, and they open up new destinations that would otherwise be uneconomic for a full-service brand.

Sometimes referred to as the airline-within-an-airline model, subsidiary airlines have proven to be difficult. The model is so difficult that North American subsidiaries have recorded a 100 per cent failure rate.


A beacon of hope for the model remains with Australia’s Qantas and the launch of its successful subsidiary, Jetstar. One of the world’s oldest airlines, Qantas’ development of its two-brand model has been
“Dual branding with a strong subsidiary brand of reliable, accessible and trusted service; a separate entity; a separate staff structure; separate costing; independence from Qantas and a strong CEO all combined to be the winning strategy for the runaway success of Jetstar.”

so successful that Jetstar is not only a profit generator but also on the cusp of overtaking Qantas as the larger carrier.

How did Qantas do it? When Australia’s Ansett Airlines collapsed in 2001, Virgin Blue began serving the short-haul routes. Virgin Blue became so successful that it was poised to move into Qantas’ market share. Faced with Virgin Blue’s lower unit costs, Qantas answered with the launch of LCC, Jetstar, a greenfield operation, tightly run and with its own board of directors. Dual branding with a strong subsidiary brand of reliable, accessible and trusted service; a separate entity; a separate staff structure; separate costing; independence from Qantas and a strong CEO all combined to be the winning strategy for the runaway success of Jetstar. Legacy Qantas’ two-brand model has been so successful that it serves as the model for emerging LCCs in Asia.

Air Canada’s CEO claimed recently that with little room for growth, the alternative to a successful subsidiary is stagnation. With the existing high-cost Air Canada product alone, he advised, “[Y]ou’re going to have many, many years of virtually no growth.” Similar to its European counterparts, Air Canada generates profits through the less competitive long-haul routes. It loses on the short-haul services where its competitors have a large cost advantage. Yet, with WestJet and now Porter Airlines establishing partnerships on international routes, Air Canada is likely to feel competitive pressure on that front as well.

There is much riding on the Rouge subsidiary. Its success will require that it follow the Qantas’ greenfield operation of separate aircraft, new staff and new management. Establishing a new culture for the subsidiary is the key.

WestJet intends to launch its subsidiary, Encore, with a measured approach and an initial launch of Western routes before moving into the Eastern markets.
The legacy carrier and the merger option

An alternative method of growth for the legacy carrier is through merger. Mergers in the airline industry have increased considerably in the past few years.


Restricted by foreign ownership rules, all mergers have occurred within a country’s boundary. In fact, regulators cannot even consider international mergers. A country’s foreign ownership requirements (Canada’s for example) create an artificial barrier that prevents foreign individuals or corporations based in another country from owning an airline based in that country.

A recent innovative strategy, the metal-neutral joint venture, has allowed airlines to circumvent the foreign ownership restriction. Structured with indifference as to who owns the metal, or aircraft, the metal-neutral joint venture has been termed a “virtual merger.”

The old cumbersome alliances of years gone by—with Star having come into existence in 1997, oneworld in 1998 and SkyTeam in 1999—have been given a fresh look. In April 2007, some SkyTeam alliance members entered into a metal-neutral joint venture. A group of Star members followed in 2009. A similar consolidation occurred with oneworld in 2010.

Air Canada, as a member of the Star Alliance, may have benefitted from this recent realignment of the industry. Whether these large trans-world mergers will mean that Air Canada remains in a preferred position is yet to unfold.

On the downside, economic studies show that with mergers there are increases in average fares.
Air Canada is fortifying some of its Western routes...

The Canadian scene

Air Canada’s metal-neutral joint venture merger with United and Continental Airlines has allowed it to pursue an enhanced partnership on United States-Canada transborder flights. It intends to launch its subsidiary Rouge this summer. Air Canada is fortifying some of its Western routes and upping its presence ahead of WestJet’s subsidiary debut.

A 2013 KPMG report claims that LCCs are likely to take one of two routes. Some will remain aggressively low cost (the Ryanair strategy) while others (such as Virgin Australia) will compete against the legacy carriers for the higher valued customers.

CHART 2

Share (Percentage) of Total Seats for Domestic and Intra-European Flights
In Each Country Offered by Low-Cost Airlines in Summer 2010

The French government and Air France have protected the flag carrier from LCC penetration.

Source: OAG, a global leader in aviation information and intelligence.
In Canada, WestJet and Porter Airlines are firmly in that latter category. WestJet is entrenched with a fleet about half the age of Air Canada’s fleet. With its target of the Eastern market, it is said to have “moved into Air Canada’s sweet spot.” WestJet has developed the smart approach of entering into a commercial arrangement with a strategically chosen carrier in each major geographic region of the world.

WestJet’s growth has not deterred Porter Airlines. With an even younger fleet, Porter is expanding rapidly. Low-cost carriers around the world are on the rise, and Porter Airlines is part of this phenomenon. Porter Airlines maintains a strong base in Toronto with an attractive strategy of creating new passenger flows. Its chair, Donald Carty, former chief executive officer at American Airlines and chair of Hawaiian Airlines, is currently chair of Virgin America. He maintains a solid reputation in the industry. While planning chief at American Airlines, reports peg him as behind the 1985 strategy that revolutionized airline fare structures. He is reputed to have been a great help in planning Porter Airlines’ U.S. ventures.

The Porter expansion proposal is good news for consumers. Equally so are the Air Canada and WestJet subsidiary launches and their promise of further consumer options. The current upheaval in the airline sector is good news for the consumer and the economy alike.
Generally, increased competition in the airline market reduces prices and stimulates traffic growth.

Benefits of airline competition

The following questions come under this heading: Does increased competition benefit consumers by lowering airfares? Has the appearance of the LCCs and the increased airline activity economically benefitted the surrounding community?

Generally, increased competition in the airline market reduces prices and stimulates traffic growth. Southwest’s emergence in the United States reduced fares by 40 per cent. A 2008 study by the Chartered Institute of Logistics and Transportation International found that greater competition in Europe led to a 30 per cent reduction in airfares.

Of the LCCs, the best known is Southwest Airlines. So well known is Southwest Airlines that the spillover benefits to passengers by virtue of the presence of an LCC at an airport is known as the “Southwest Effect.” It means that not only are passengers no longer confined to service through the hub airport, and not only do they have more routes available to them, and not only do they benefit from lower airfares, but the effect of the lower airfares is so widespread that it extends to a fall in fares in the vicinity.

On the question of the benefit to Toronto, Porter Airlines claims that its expansion at BBTCA will create 1,000 new jobs and double the current value of its economic benefits to Toronto to nearly $4-billion annually.
These numbers align with economic analysis. Economies, claims York University economist Fred Lazar, require the good working order of their finance, telecommunications, energy and transportation sectors. Due to its ability to expand markets, increase employment and investment, spur competition and magnify the benefit of trade liberalization, Lazar finds air transportation to be the most critical industry in an economy, with a dollar invested in the industry likely to produce a larger benefit than a dollar invested in other sectors.

Andrew Steinberg, former U.S. Assistant Secretary for Aviation and International Affairs, claimed that that relationship between increased activity at an airport and its economic spinoff became the driver of U.S. Open Skies. Every dollar spent in aviation, he claimed in 2009, creates $5.00 worth of economic activity, and one job in aviation supports 10 jobs elsewhere.

Famed flying ace Billy Mitchell claimed in 1929 that he was able to foretell the health of a city by its airport. “To measure the heartbeat of your city, take the pulse of its airport,” he stated. The bustle at BBTCA suggests a healthy Toronto.

Increased competition in the skies benefits consumers by lowering fares and increasing travel options. Increased airline activity provides significant economic advantages to the surrounding community.
About the author

Mary-Jane Bennett is a lawyer, transportation consultant and Fellow at the Frontier Centre for Public Policy. She began her career with the Ontario Ministry of Justice, and she has practised law in Manitoba and British Columbia. In 1997, she received an appointment by the Governor-in-Council to the newly formed Canadian Transportation Agency in Ottawa where she sat as a board member on a wide range of transportation issues. She served on the board from January 1998 until May 2007.

Further Reading

May 2012

Grain Freight Regulation in Canada

By Mary-Jane Bennett

http://www.fcpp.org/publication.php/4202

August 2012

Airport Policy in Canada

By Mary-Jane Bennett

http://www.fcpp.org/publication.php/4292