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Lining up Nose to Nose

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The Rise of Canadian Ultra-Low-Cost Carriers

Once upon a time, WestJet Airlines was the new kid shaking up the skies, offering Canadians discount fares never before seen. With base fares as low as $29, back when minimum wage ranged from $5 to $7 an hour across Canada, WestJet created a new class of accessible and affordable air travel.

It was February 1996. Bill Clinton was president, the IRA was bombing London, and Jerry Maguire was a box-office hit.

Over in Calgary, with just three used Boeing 737-200 aircraft, 225 employees and routes between only five western cities, the little-airline-that-could, did. WestJet took on and beat the now-defunct Canadian Airlines, Canada's second-largest airline at the time.

And Air Canada, the country's largest carrier? It largely stood by on the tarmac, watching the match unfold between its nemesis and the fledgling carrier. Allegorically speaking, Goliath was slain, and it was a win for both David and Air Canada, which took control and absorbed Canadian Airlines in 2000.

Two decades later, history looks to be repeating itself, but with a compelling plot twist.

Now Canada's second-largest carrier with 12,000-plus employees and more than 163 planes, this time it's WestJet that's fending off the upstarts. At least three ultra-low-cost carriers (ULCC) are planning to bring the unbundled, no-frills model to Canada. In a pre-emptive strike against the new competition, WestJet announced plans to start its own ULCC, Swoop, in June.

"It's poetic justice," says transportation economist Barry Prentice, who teaches at the University of Manitoba's Asper School of Business. "The ultra-low-cost carriers are doing to WestJet what WestJet did to Canadian Airlines International, 20 years ago."

To some, the storyline reads more like a fantasy than non-fiction. WestJet is now a legacy carrier, with all of the costs and complexity that comes with it. Its strategic direction appears unfocussed; expanding internationally, moving into business-class services and now a return to budget travel? It's also happening at a time when WestJet lost the battle against unionization. Is WestJet spinning its wheels?

Swoop seems like a backward move given that it was WestJet that left the market open for a new breed of low-cost carriers when it raised its prices.

Prentice is one observer who isn't buying that WestJet truly wants to bring a ULCC to Canadians, having abandoned its discount-fare model long ago. He believes WestJet is launching Swoop for no other strategic reason than to defend its duopoly with Air Canada. If it does succeed in killing the ULCC competition, Prentice fears Swoop will also be grounded, leaving air travellers as the big losers.

"I don't think anybody really expects that WestJet is keen in the long-term to offer low fares and service like this," says Prentice, who is also a member of the University of Manitoba Transport Institute. "It's doing this because it wants to protect its market share …. If WestJet succeeds in pushing out the new entrants, then they go back to where they were. I don't think they'll carry on. There's no particular reason for them to do this logically, except to make sure that other new entrants don't come in."

In the long-term, prices may even go up, says Prentice.

"You can put two and two together," said Prentice. "There's the risk that the incumbent airline will need to, or try to, increase its margins to make up for whatever it lost in fighting the battle to keep the new entrants out," he says. "The consumers could end up worse off."

WestJet declined the request for an interview but provided the following statement from executive vice president Bob Cummings: "We believe there's only room for one major ultra-low-fare carrier and Swoop is best suited to be it. There is significant demand in the Canadian market to stimulate traffic at lower fares. With our launch only months away, we expect to be serving the Canadian market far into the future."

Once again, Air Canada appears to be watching the ULCC battle in Canada play out from the sidelines. If need be, Air Canada could try to compete through its low-cost subsidiary Rouge, which offers moderately lower fares for international vacation destinations. Rouge planes have been reconfigured to increase capacity per flight. Labour costs have been reduced by recruiting younger, less experienced flight attendants at a lower starting wage than at its mainline carrier.

Air Canada has also renegotiated contracts with its pilots' union, to better position Rouge with more flexibility to fly domestically should a ULCC pose a direct threat on one of its routes.

But Rouge is not a ULCC, nor are its prices as low as those offered by ULCCs, which is what analyst Juan de la Hoz partly attributes to its success. In a report on Air Canada's latest quarterly earnings, he writes this about Rouge:

"By not simply copying the business plan of ultra-budget airlines (think Ryanair), the subsidiary has outperformed in the short-term, as fares haven't decreased as much, and is likely to be relevant in the future as newer airlines have greater ability to operate budget airlines, due to less legacy pension liabilities and old operation/habits," says the report, published on stock-market insights' site Seeking Alpha.

Air Canada announced good growth for Rouge during the quarter ending Sept. 30, without reporting specific figures for the subsidiary. WestJet also reported strong quarterly earnings, and while it insists it will operate Swoop as a completely separate company – building it from scratch with greater efficiencies and lower labour costs – it too plans on reporting the financials together with the parent company, making it easier to mask things like debt at Swoop or subsidies from WestJet.

Canada — History of high costs, high fares

Only in the Great White North do we pay sticker-shock prices required to travel from one place to another within our own country. We often pay more to visit grandma in Cape Breton, N.S. than to travel to London or Paris, or for an all-inclusive sun destination.

Airlines like to blame higher taxes, fuel costs and Canada's vast geography and sparse population for the higher fares. Much of it, though, comes down to the fact that the two mainline carriers — Air Canada and WestJet — have extremely high-cost structures.

The key measure used to report costs in the airline industry is the operating expense (cost) per available seat mile, or CASM, an industry measure of how much an airline spends to fly a passenger. Air Canada's CASM

(including fuel) for the first nine months of 2017 was 14.1 cents. WestJet's was 12.96 cents for the same period.

ULCCs, by comparison, report significantly lower CASM. Europe's Ryanair reported a CASM for the year ended March 2017, when converted to Canadian dollars, of 7.52 cents. European carrier WizzAir maintained a CASM of 7.27 cents CAD for the 18 months ended Sept. 30, 2017. U.S.-based ULCC Spirit had a CASM of 7.72 cents CAD for the six months ended June 30, 2017.

Another key cost measure is the number of employees per aircraft.

As of Sept. 30, 2017, WestJet had an average of 11,001 full-time equivalent (FTE) employees during the previous nine months. Its average aircraft during that same period was 163, equaling an average FTE per aircraft of 67.5.

For the first nine months of 2017, Air Canada's FTE ratio was 125 employees per aircraft, based on 27,700 employees and 221 planes (excluding both additional employees and aircraft Air Canada acquires through its capacity purchase agreements with third-party regional carriers, such as Jazz.).

ULCCs, on average, have much lower FTE per aircraft. For example, Ryanair was at 32.5 as of March 2017 (the last release of such detailed information in their annual report). EasyJet was at 42 in the second half of 2017.

WestJet has indicated to investors that Swoop's FTE per aircraft will average 50 and CASM will be 8.7 cents CAD, but only when economies of scale reach a certain level.

The big question is how will WestJet get Swoop's costs down by more than 30 per cent, when the company is currently facing unionization and cost keeps going up? Indeed, WestJet reported CASM will continue to increase in the fourth quarter of 2017 and throughout 2018.

Why now?

This promise of ultra-cheap fares comes to Canada more than three-decades after Europe got Ryanair, its first ULCC, which today is one of the world's largest and most profitable ULCCs.

A big reason is thanks to the federal government's relaxation of foreign ownership rules, as it moves to change the law this year to allow up to 49 per cent foreign ownership of Canadian airlines, an increase from 25 per cent today. It's already granted that permission to upstart Canada Jetlines Ltd. (TSX.V: JET), and Calgary-based Enerjet, which launched as a charter service in 2006 and wants to transition to a ULCC, under the name FlyToo.

Vancouver-based Jetlines hopes to be flying by the summer of 2018, aiming service to six cities, including Hamilton, Ont., Abbotsford, B.C., and Halifax, N.S.

The increase in foreign ownership is critical to an airline's ability to raise capital. For startups, cash in hand, and plenty of it, is integral to the equation of success, particularly when it involves launching the kind of offensive that's required to break a duopoly. But breaking a duopoly can and has been done.

Ryanair did it when it launched in Ireland in the mid-80s and triggered Europe's first price war on air travel between London and Dublin. It eventually broke the duopoly held on the route by British Airways and Irish government-owned Aer Lingus.

Today, Ryanair still offers 9.99 EUR (about $16 CAD) one-way fares between the two cities and is one of the largest, most profitable ULCCs in the world. It made record profits this year, even as it cut fares.

How cheap is cheap?

The best rates so far seem to be those promised by Jetlines, which says it will launch with $10 flights for the first 1,000 tickets it sells. Base fares will sell for less than the cost of a pair of jeans, or around $100.

WestJet has indicated to its investors that Swoop's fares will be about 40 per cent lower than current fares. They expect to somewhat offset costs by doubling ancillary fees, which are about $19 per guest on its mainline carrier.

NewLeaf launched two years ago by offering $99 fares, which are now widely gone after the airline ran into troubles and got acquired by Kelowna, B.C.-based Flair Airlines. Flair's fares are hardly deep discounts, but somewhat cheaper and less of a hassle than cheaper fares on the mainline carriers.

For example, a search for a direct flight on Flair from Edmonton to Toronto for a five-day trip in December started at $512.37 non-stop, return. For the same route and same dates, WestJet fares started at $685 return, but that required spending an 11-hour and 38-minute-layover in Winnipeg. The cheapest non-stop return flight was $1,009 on WestJet and $1,156 with Air Canada.

Even at 40 per cent off WestJet's current fares, Swoop won't come close to $100 base fares without drastically cutting its costs. Doubling ancillary fees barely bridges the gap, bringing in all of $38 per guest.

The business case — ultra-low costs, ultra-high profits

Analysts are skeptical that Swoop can follow the so-called "bible" of the ULCC model when it comes to controlling its costs.

"It's about lowering prices and fares, but at the same time, lowering costs to where they are profitable," says Chris Murray, an airline analyst with AltaCorp Capital. "If you look at all of the ULCCs, both in the U.S. and Europe, this has been a very profitable business model."

The ULCC model is profitable because true ULCCs are able to demonstrate cost discipline throughout the entire company and keep their CASM low. They do this by running a simple business model that only has one class of seats, flies one type of aircraft, and uses lower-cost secondary airports when possible. Ultimately this allows them to sell fares 30-to-50 per cent lower than mainline carriers, realize high passenger loads, and turn profits.

Jetlines, in addition to unbundling services and stimulating new demand from passengers who typically wouldn't travel, plans on adhering to cost controls that include the following:

- Standardization of plane size and seating options.
- A low-cost culture whereby every employee is motivated to drive costs down and take pride in the company.
- Reduced labour costs: Employees take on multiple roles, some positions are contracted out and the environment is positive. "Jetlines has determined that the following are key to a positive work environment: respectful work environment free from harassment; defined conditions of service; a fair arbitration process; ample time off and the ability to control that personal time," states the company in its investor presentation.
- Flying out of secondary airports, such as Hamilton, Ont. and Abbotsford, B.C., which have just 20 per cent of the costs of flying into Toronto's Pearson International, Canada's largest airport.

Analysts say WestJet will have a number of challenges, particularly around labour and employee morale. WestJet employees are no longer the happy WestJetters they once were. Swoop comes at a time when pilots with both WestJet's main and regional carriers are unionizing. Flight attendants are expected to be next.

Observers are also concerned by the many strategic initiatives underway by WestJet and its wholly owned regional carrier, WestJet Encore. They fear the company is juggling too many initiatives, some of which have the airline going in seemingly opposite directions.

"Whether WestJet can get costs down to an ultra-low-cost carrier level, personally, I think that will be a tough thing to do," says Cameron Doerksen, a transportation analyst at National Bank. "Even if you put labour aside, you still have a number of functions supporting Swoop that are corporate and at WestJet's mainline cost structure …. WestJet as a whole is a mature airline at this point. Any new startup, starting from scratch, is always going to have lower costs, initially."

In May, a month after announcing it would launch a ULCC, WestJet announced the purchase of 20 long-haul jets, launching itself as a bona fide high-flyer that can compete with the big global players. The Boeing 787-9 Dreamliner aircraft represents an investment in the latest technology. With a range of 14,000 kilometres and a fuel efficiency that's 20 per cent greater than the Boeing 767s, the Dreamliner allows WestJet to serve new destinations in Asia and South America, and expand its service to Europe.

It also plans to go after most business-class customers, a market long-dominated by Air Canada. WestJet announced last fall its plans to build nine VIP lounges at airports including in Calgary, Vancouver, and Toronto.

"[WestJet] started off as copying the Southwest Airlines model, which is one type of plane, flying from second-tier airports, low number of flights, no business class, no points, no connections and no partners," says Karl Moore, a professor of strategy and organization at the Desautels Faculty of Management at McGill University. "They now have three to four types of aircraft, a kind of a business class, and a much more complex network."

Moore says every layer of complexity increases the expense structure. "It's a concern. When you do each of these things additionally, it adds costs, therefore you've got to pass those costs onto your customers," he says.

Murray of AltaCapital is concerned about the company's decision to pursue multiple strategies. "One is in the international wide-body market. One is in the ultra-low-cost carrier market, and frankly those strategies, in our opinion, are diametrically opposed," Murray says. "It raises the issue about how complex the number of initiatives the company has underway simultaneously in a climate where you actually have ongoing unionization issues. It's challenging."

WestJet argues the goal for Swoop is nothing more than mere profits. There's money to be made with the ULCC model and it wants to be the dominant player. However, it also says the money to be made will come by stimulating new demand from passengers who currently don't fly because they can't afford today's prices. It believes Swoop won't be profitable at the expense of ceding traffic from its other airline brands.

Yet, there's only so-much profit that can come from new demand due to price stimulation — people who normally would either drive or not travel. For Jetlines, this segment accounts for a mere 10 per cent of its target customers, or 10.7 million of a total of 113 million customers.

Jetlines anticipates some 70 per cent of its market opportunity will come from the competition — customers who currently fly with incumbents. In its investor presentation, the upstart has a target of 113.2 million customers for 2018, of which just 10.7 million are expected from new demand stimulated by lower price. Some 24 million customers account for those flyers who currently drive to airports south of the border in search of cheaper fares. The rest, Canada Jetlines Ltd. (TSXV: JET) is banking will come from a shift in market share.

In other words, it expects to cannibalize market share from the incumbents, and at a significant rate. If this is key to the winning formula for an incoming ULCC, how then can Swoop expect to become the dominant ULCC in Canada, without cannibalizing its own customer base and stealing current WestJet flyers?

If Swoop can't get its cost structure as low as the ULCCs with whom it will be competing, and if it can't fill its planes purely from new demand, without stealing traffic from its sister airlines, how can it possibly be profitable? So, if not profits, then what is its real business objective?

"It does seem like WestJet is trying to be all things to all flyers," says Todd Hirsch, chief economist with ATB Financial. "That model might work, depending on who they have managing their new Swoop, but I think it's a very different business model."

Brand confusion will be just one of the many risks, Hirsch says.

"As you go after business travellers, and the high-end vacation travellers and the budget-conscious travellers, the marketing around all of that is very different, and the scheduling is very different," says Hirsch. "The ULCC product is really a different market — sort of like high-end restaurants and fast food joints."

University of Manitoba's Prentice agreed.

"But I've never seen McDonald's try to open a white-table restaurant," says Prentice. "And I've never seen a white-table restaurant try and open a fast-food restaurant."

That doesn't mean WestJet and Swoop are doomed to fail, he added, saying there are a thousand variables involved in the equation of success. "This is an uncontrolled experiment and we're going to find out what happens."

History of failure

If history is the greatest predictor of the future, the skies look gloomy for Swoop given the number of failed airlines within airlines attempted in North America.

Dozens of legacy airlines have tried to start low-cost carriers in North America and have failed, time and again, for reasons that apply equally to WestJet and Swoop. Can they get costs low enough? Will they get the right routes at the right times? How will they distinguish between the two distinct brands, cultures and operating models, and keep internal employee cohesion?

Here's a partial list of obituaries:

- Continental Lite, a subsidiary of Continental Airlines (1993–1995): It suffered from brand confusion, unprofitable routes, and the lack of parts available at airports for the older planes in its fleet.
- United Airlines/United Shuttle (1994–2001): Launched to compete with Southwest Airlines, but customers failed to differentiate between Shuttle and the mainline services. Costs were also nowhere near as competitive as Southwest.
- Delta Airlines/Delta Express (1996–2003): Larger planes contributed to longer turn-around times and discontinued services to small cities. Fares weren't competitive enough. Productivity was too low, and there was brand confusion.
- MetroJet/US Airways (1998–2001): Failed to lower costs enough to compete.

- Zip/Air Canada (2002–2004): Absorbed into Air Canada's full schedule on western routes after it bled money to match WestJet's fares. Media reports at the time stated that Zip was a failed attempt at preserving market dominance and driving out the competition.
- Song/Delta Airlines (2003–2006): Pushed out by the competition. Didn't operate at full capacity.
- Ted/United Airlines (2004–2009): Couldn't survive a spike in fuel prices; brand confusion as Ted customers could book flights on the United sites, which meant airline competed with itself.

Will history repeat itself? While North American airlines have failed to launch discount carriers, Australia's Qantas Airways has had great success with its wholly owned discount subsidiary, Jetstar. It's this model WestJet says it will follow and try to bring successfully to the North American market, with Swoop.

"Historically, brand shifts in an airline, or airlines within airlines, that's always been a bit tricky," says Murray. "Tango didn't work. Rouge has … I'm not saying it's doomed to failure, it's just that it's certainly got its challenges."

Hirsch says WestJet will need to be "very careful in how they do this, because you are now extending your management team to trying to understand all of these different markets. It might work, but you can also see how it might flop on them."

History poised to repeat itself

While experts predict a price war when ULCCs hit the market, they caution the survivor in this latest battle of the skies won't necessarily be the biggest airline or the one that is most financially fit. It will be the carrier or carriers that best understand the ULCC market.

"The main carriers WestJet and Air Canada might indeed succeed in driving out the ultra-low-cost carriers, but that's certainly not one hundred per cent certain," says Hirsch.

"If the new ULCCs can understand that market and model better than the big guys can, they'll succeed. The big ones might be wiser to focus on what they can do well — business travel and higher price-point consumers. If they try to do too much, being all things to all market segments, they may actually be the ones that fail."

Hirsch says the new ultra-low-cost carriers have a chance. "They'll have to be very smart and out-wit and out-market the big guys," he says. "But they have the advantage of being able to focus on one very-specific group of travellers. The big ones might lose focus and stumble."

It's been done before, ironically by WestJet, decades ago. However, today it seems Swoop could be heading into a lot of turbulence — if it gets off the ground. Canadian travellers and investors would be wise to hope and help, history repeats itself, so that a true ULCC can overpower the incumbents and finally soar successfully over Canadian skies.