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CRISIS IN THE CANADIAN AIRLINE INDUSTRY: DE-REGULATION, CONSOLIDATION, AND THE IMPLICATIONS FOR WESTERN CANADA

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INTRODUCTION

Financially the airlines may be falling, but, rumours aside, the sky is not falling. The proposed merger of Canadian and Air Canada has again drawn the public's attention to an ailing industry. As major change continues to sweep the airline industry, many Canadians are asking questions like: Will Canada emerge with only one scheduled airline? Is this consolidation a natural consequence of deregulation? Why was this result not foreseen? Should we re-regulate the industry? Does it matter to the Western Provinces? Can changes be introduced which provide an opportunity for Western Canada to benefit? In this bulletin we address these and other questions.

In looking at the current situation, it is important to remember how the world looked under regulation: It was far from perfect. It is fair to say that recognition of the problems associated with regulation motivated the Americans to deregulate, and that American deregulation strongly influenced Canadian Policy.

THE WORLD OF AIRLINE REGULATION AND WHY IT CHANGED

The explanation for the advent of regulation in the United States and Canada depends on perspective. Some economists, such as Milton Friedman, maintain that the industry was regulated because managers, owners, and employee groups benefited from regulation and feared competition.

The industry, in contrast, maintains that regulation was necessary for three reasons. First, regulation ensured safe operation. Second, regulation allowed carriers to overcharge some passengers on high-density routes in order to cross-subsidize passengers on uneconomic routes. Third, economies of scale were important in the industry: as the size of an airline grew its cost per passenger mile declined. Because of these economies of scale, it was desirable to have regulated monopoly carriers. These would operate with high load factors (percentage of seats filled) and at low cost.

In the United States, each of these assumptions came under critical review in the early 1970s, and each was found to be false.

First, effective regulation of airline safety was found to be unrelated to economic regulation.

Second, studies by a U.S. Senate committee and by independent economists revealed that cross-subsidy rarely occurred. Regulated carriers were found to operate few flights that did not contribute financially. Unprofitable flights usually were either eliminated or turned over to smaller carriers.

Third, studies showed that airline costs per passenger mile declined but only until the number of aircraft operated reached twelve. This meant small carriers could be as low cost as large carriers; effectively, monopoly carriers were not more efficient.

Fourth, studies revealed that unregulated flights that took place *within* California had much lower fares than those on shorter flights which went across the California border. The latter(interstate) flights were regulated by the U.S. government; the former were unregulated. Thus, regulation was resulting in higher prices.

Finally, regulation inflated costs because almost all airline employee groups were unionized, and regulators permitted carriers to pass wage settlement costs to consumers. Airline costs had become bloated. For example, a machinist or a janitor working for a regulated airline was typically paid 30 to 40 per cent more than the same person working for an unregulated firm. Similarly, managers did not concern themselves about operating efficiency. Additionally, there is some evidence that airlines over invested in jet aircraft.

Having found fallacious all the assumptions used to justify regulation, the

U.S. Congress(in 1976), passed legislation to deregulate.

Events moved more slowly in Canada, but the pattern was similar. Through 1979 the Canadian industry remained strictly regulated. Five regional carriers served provincial markets. In addition, Wardair operated tightly restricted international charter services. Canadian Pacific served British Columbia as a regional, had twenty-five percent of the Vancouver-Toronto seating capacity, served South America and the Pacific, and connected with one American city. Air Canada provided trans-Atlantic, transcontinental, interprovincial, and some purely regional service. It served 14 American cities.

The Canadian Transportation Commission regulated the system. The regionals had their monopolies; Air Canada and CP-Air had their monopolies; and CP-Air was allowed a small portion of the Toronto west trans-continental traffic. Air Canada typically requested fare increases when its costs rose, and the other carriers requested identical increases. Through 1977, requests were routinely granted.

The inflation of costs closely paralleled those in the U.S. under regulation. Two differences were notable: Air Canada consistently overinvested in aircraft (the L-1011 being the classic example), and many operating and investment decisions were politically driven (location of maintenance facilities, for example).

As in the U.S., no new entry into the market was allowed. This was exemplified in 1977 when Wardair's effort to expand charter competition was blocked.

To summarize, Canada had a high cost industry with very little competition. The world, however, was changing.

TO DEREGULATION AND BEYOND IN CANADA

Between 1977 and 1984 several changes occurred in the industry that drove Canada toward deregulation. First, changes in the United States were highly visible, and fares fell dramatically. The differences were highlighted when Wardair started operating "international" charters from Seattle to Toronto and Buffalo to Vancouver for half the fares charged for trans-continental scheduled service within Canada.

Second, the criticisms of the traditional arguments of safety, cross-subsidy, and monopoly, that had been so important in the U.S. in bringing down regulation, were being increasingly heard in Canada.

By 1983 the Liberal government was moving toward deregulation. National hearings were conducted on the question of deregulation in 1984. In those hearings the safety arguments were rejected; Air Canada, CP-Air, and PWA all admitted there was no cross-subsidy in their systems; and the economic evidence that economies of scale in the industry were unimportant was not challenged. The new Conservative government was, apparently, impressed and moved quickly to deregulate the industry, with complete deregulation scheduled for 1988.

Other important changes occurred in Canada between 1984 and 1988. CP-Air bought Eastern Provincial, QuebecAir and Nordair. Then, after continuing financial problems and a major but unsuccessful managerial shake-up between 1984 and 1986 (which saw the turnover of 25 of its 30 top managers as it tried to integrate seniority lists, aircraft, and the very different organization cultures of the four acquired regionals in order to get costs down for survival in a deregulated environment), CP-Air was sold to PWA Corporation and became Canadian.

PWA had benefited from its regional monopoly, a management that focused on costs (relative to other Canadian carriers), and, in the 1970s, from the West's economic prosperity. By 1986, management was convinced that a regional airline had no future. PWA had a lot of cash and little debt; CP-Air was for sale, and Air Canada was not.

Wardair, given the green-light with deregulation, proceeded to become a scheduled carrier but failed miserably. Wardair was a gold medallist as a charter carrier, but never understood the scheduled airline business. It very quickly failed in scheduled service efforts because management was inadequate in a variety of ways. These included: failure to understand the importance of a feeder network; failure to purchase the 'right' aircraft; failure to understand the importance of frequent flyer programs; failure to act on the importance of and the conditions for attracting full-fare business passengers; inability to change the charter focus of the organization's culture; and failure to understand that competitors would not passively yield market share. In 1989, Canadian bought Wardair as the latter approached bankruptcy.

During the same period Air Canada and Canadian developed alliances with, or bought out, almost all local-service and commuter carriers.

Retrospectively, PWA-Canadian's downfall began with the PWA CP-Air merger. PWA, a cost driven carrier in which most marketing managers had accounting backgrounds, grossly underestimated the levels of inefficiency and high costs of CP-Air and underestimated the importance of marketing in the new national competition. Its work force was also largely alienated from the company. While its President, Murray Sigler, seemed to understand the marketing and human resource management problems, management generally did not.

Thus, Canadian entered head to head competition with Air Canada severely handicapped by marketing, organization culture, and--relative to Air Canada--financial resource constraints. It had a slight advantage in cost levels and operating efficiency.

As we entered 1992, with a privatized Air Canada, the Canadian airline system was essentially two scheduled carriers. Limited competition was allowed for some U.S. and some non-North American carriers, and several small carriers had begun to offer trans-continental charter service. Negotiations were continuing with the Americans on allowing more trans-border competition. But a crisis was coming.

THE CAUSES OF THE CRISIS

The current crisis in the airline industry in Canada was precipitated by several factors: changes in the United States and what they portend for Canadian carriers; the high costs of Canadian carriers; the severity and duration of the Canadian recession; the excess capacity of Air Canada and Canadian-aggravated by the recession; the problems created by the Federal government in leading Air Canada to believe that it would be allowed to compete in the Pacific market if Canadian was allowed to expand over the Atlantic; and the collapse of Air Canada's negotiations with USAir. We explore each of these.

The American airline industry looks very different today than was expected in 1978. What happened? First, the introduction of frequent flyer programs caused passengers, particularly full fare business passengers, to choose carriers maintaining a presence in all markets. Carriers without good domestic systems--large "catch basins"--were particularly disadvantaged since customers benefit from concentrating their frequent flyer points in one plan and desire to accumulate points for all flights. Those carriers lacking international flights to major markets were also handicapped. These competitive implications of frequent flyer systems were not generally recognized until 1985.

Second, the computerized reservation systems introduced by large carriers favored their flights. In addition, most travel agents did not desire to be connected to more than a couple of systems. While government mandated changes eliminated some biases, the carriers that owned the systems still possessed advantages because their flights appeared on screens first, and they charged other carriers for use of their systems.

Third, the development of sophisticated, computerized seat management programs allowed scheduled carriers to meet competition by matching low prices on some seats without cutting all prices.

Fourth, as fares dropped and passenger traffic grew, U.S. airports did not grow proportionately. The number of gates at major airports was limited and the established carriers controlled them. New and regional carriers trying to expand found themselves locked out of important parts of the national market. The important implications of this problem were not apparent until 1985-86 as the U.S. emerged from the severe recession of the early 1980s, and air traffic expanded.

Fifth, the growth in air traffic and the congestion at airports reinforced passengers' preferences to fly with single, large carriers. For example, scheduling is easier (flights are better synchronized within systems and a connecting flight is more likely to be held for a delayed arriving flight on the same carrier), connecting flights will almost always be in the same terminal, and there is a lower probability that checked luggage will be lost when only one carrier is involved.

Sixth, many of the large American carriers have developed sophisticated capabilities in the design and use of computerized management information systems; capabilities they use as a strategic competitive tool. In some cases the carriers generate significant revenues by contracting out these capabilities; for example, American Airlines earned over $500 million in 1991 from selling these services.

Finally, bankruptcy laws which allowed insolvent carriers to continue operating, the extended recession, and high debt loads from the 1980s have compelled the surviving American carriers into ever more effective cost control and demand management.

In sum, the overall consequence of the above changes in the U.S. industry is that the few surviving carriers have become very large, very lean, and very competitive: their costs are low and their domestic networks are extensive. All have, or are in the process of developing, international alliances or networks.

Should North America move to open competition, the estimates are that Air Canada will have to reduce its operating costs per seat mile by at least another 25 to 35 per cent; Canadian needs at least a 10 to 15 per cent reduction to match the levels of the American carriers. While the Canadian carriers dispute the exact cost differences, they do not deny their higher costs. However, they legitimately point to government as an important source of their problems because of higher fuel and other taxes in Canada, as well as other inflated costs due to regulation in supplier industries. A level playing field may require new legislation to include rebates of fuel taxes to all carriers purchasing fuel in Canada and a review of airport taxes.

But cost disadvantages are only one part of the long run competitive problem resultant from changes under deregulation in the U.S. The development of domestic networks with a lock on airport space concedes American based carriers a significant advantage in any North America wide competition. The existence of customs and immigration pre-clearance in Canada (unrelated to deregulation) aggravates the problem for Canadian carriers.

While the Americans have deregulated their domestic industry, they have not allowed open access to foreign carriers. In addition, Air Canada has not been particularly successful in developing the routes it does possess into the U.S. This lack of opportunity and lack of effectiveness, when combined with the absence of gates at major airports, means that Canadian carriers will be at a long-term disadvantage in accessing American passengers. In contrast, a substantial excess capacity of gates at Canadian airports means that American carriers will not be equally disadvantaged in any future competition.

Pre-clearance at Canadian airports also benefits American carriers since passengers departing Canada can flow right into the remainder of an American carrier's total system; they need never claim their luggage until they reach their ultimate destination. If they start out on a Canadian carrier they may need to change to an American carrier and, in the process, shift to a different carrier's frequent flyer system.

On the other hand, passengers departing the U.S. for Canada clear immigration in Canada. There is little advantage in coming to Canada on a Canadian carrier.

Finally, the probability that a Canadian originating passenger is going to a destination in the U.S. in a Canadian carrier's network is much less than the probability that an American originating passenger is destined for a Canadian airport in the American carrier's system.

In the longer term both Canadian carriers are severely disadvantaged by their lack of U.S. networks. This is one reason Canadian was looking to an alliance with American, and Air Canada was looking at USAir and Continental. This is why British Airways was prepared to outbid Air Canada and to pay $750 million for USAir. It remains problematic whether either Canadian carrier can survive long-term in an open North American market without such a network or, at the vary least, an alliance with a networked carrier. The two Canadian carriers recognize this reality.

The competitive importance of a strong American system or "catch-basin" cannot be overemphasized. All other things equal, in an industry where operating margins are very narrow, being able to count on first-draw to the revenue generated by any substantial block of customers not available to a competitor is all that one competitor needs to win the consumer. When it is remembered that the entire Canada "catch-basin" has a population equal only to that of California, the competitive problems become apparent.

THE CURRENT SITUATION

Thus, the long-run prospects under North-American competition are of concern. In the short-run, the domestic situation took a turn for the worse as the recession lengthened and deepened. Both carriers found themselves with substantial excess capacity and stagnant domestic and international markets. The result: recurring operating losses. Air Canada's problems were aggravated by taking of delivery of aircraft in anticipation of being allowed to enter the Pacific market only to have the Federal government reverse itself. Because of a desire to minimize losses, to drive Canadian out of business, or both, Air Canada aggressively cut prices in 1992. The continued price cutting, high debt loads, and the failure of the economy to improve have left both airlines in serious financial circumstances.

The collapse of Air Canada's negotiations with USAir, together with the possible merger of Canadian with American, brought the crisis of July 1992 to a head. It is now clear that Canadian is in deep financial trouble and can only survive with government intervention and assistance, a full, or partial, employee buyout, or through merger. A merger with American Airlines is contingent on substantial, but not transparent, direct and indirect government financial assistance. In effect Canadian needs a government bailout in order for it to be taken over by a foreign firm. A merger with Air Canada would likely occur on terms unfavorable to Canadian.

In the absence of government direct or indirect financial assistance, Canadian will be merged only at substantial losses to its owners. Short-term, the industry is in a financial crisis, and long-term the carriers are pessimistic about their global competitiveness and high debt levels. Employees fear massive job losses. Consumers, fear a significant reduction in competition.

clearly has a greater probability of negative consequences for development of airline and related knowledge based industry clusters in Western Canada than does a limited merger with an American carrier. To the extent that more dynamic managerial and other high level employment tends to be concentrated at head office locations, the loss of those centers has negative implications for the development of new firms in existing and yet to be developed industries. This is particularly important in Western Canada where there are so relatively few head offices of non-resource based businesses.

Another important question for Western Canada of course is: does its economic, as opposed to its political, future lie with the U.S. and the Pacific Rim, or with Central Canada? To the extent the answer is the former, then moving ahead rapidly with an alliance between Canadian and a major American carrier makes economic sense for the region.

A National Perspective

From a national perspective, should Air Canada prevail, then, after the acquisition of Canadian and after the disposal of quite a few aircraft, it will be able to significantly increase load factors and improve its revenue per passenger mile. Combined operating costs for the integrated carriers will also be reduced as Air Canada reduces combined flight frequencies and lays off an undetermined number of employees.

A merger with Air Canada of some type will potentially result in a strong national carrier domestically, a carrier with good international routes to the Atlantic and Pacific markets, and a carrier with routes to major U.S. cities. After an alliance with an American carrier and, perhaps, one with a European carrier, a new Air Canada may have the capacity to survive in increasingly global markets. Canada will potentially have one of the few surviving global air carriers.

Some industry analysts have observed that a merger may cause an alliance with Air Canada to become much more attractive to several American carriers and significantly increase the probability of an alliance on terms favorable to Air Canada. Obviously, this will have significant employment and foreign exchange implications for Canada long-term.

Even though Air Canada would remain a relatively high cost carrier, the shock of recent changes might induce management and labour to take a more realistic view of operating efficiency, cost control, and consumer sensitivity. It might also induce a greater awareness on the part of government of how the relatively high taxes and the effects of a broad range of regulatory activities in Canada, relative to the U.S., disadvantage business in Canada.

On the down side, a new Air Canada would face what some analysts view as an overwhelming four to five billion dollar debt load and equity of well under one billion dollars. These financial analysts have argued that the debt/equity ratio will be so high as to make the carrier unviable financially. None has seen fit to publicly disagree.

Investors have responded, however. While American is reported to have offered $7.50 per common voting share, and shares of PWA were trading above $5 most of June and July, share prices fell to under $3 after negotiations with American ended and those with Air Canada began. In effect, investors saw the forced negotiations leading to a merger of PWA with Air Canada as likely to destroy the value of PWA.

THE CURRENT OUTLOOK AND GOVERNMENT POLICY

There are, however, some aspects of an Air Canada merger and the related policy changes to enhance competition outlined above that may be found unacceptable by the Federal or Provincial governments. These include concern about significant employment losses and uncertainties about their actual magnitude. These concerns may lead the Federal government to mandate employment protection provisions in any agreement as a precondition for merger approval. The risk, of course, is that Air Canada will be competitively disadvantaged long-term by the resulting costs.

There is also concern about the presumed vulnerability of smaller communities from reduced competition. This could induce some type of protective action in spite of the fact that most industry experts will agree that local service fares are generally driven more by inter-modal than intra-modal competition. The real constraint on the pricing of short distance airline passenger service is the automobile.

Possible options would include the use of some type of formula pricing to set ceilings on fares. Another would be a requirement that Air Canada divest itself of the commuters but allow existing and new local carriers to join the Air Canada frequent flyer program on reasonable terms--perhaps to be reviewed by the national transport authority. Concern about the commuter situation may be important because of the very large increases in employment growth in that sector of the industry in recent years.

There are also some purely political factors. There is the danger that public hostility to the Free Trade Agreement and its perceived economic consequences, as well as public attitudes toward the American approach to dispute resolution under the agreement, may have created an atmosphere where any further change in bilateral, transborder arrangements with the U.S., at least in the short-term, is not politically acceptable.

One other largely political factor might upset the preceding. The resentment in English Canada, particularly in the West, at discovering that the privatization law for Air Canada mandated that the organization's headquarters must remain in Quebec may lead to strong pressure to allow an American carrier to acquire Canadian. This resentment may be increased if CN, with its head office in Quebec, but over sixty percent of its business in Western Canada, proceeds with major employment cutbacks.

Finally, intervention by provincial governments in Western Canada on behalf of Canadian could force Air Canada out and PWA back to negotiations with American. This outcome became more probable with knowledge that American planned to operate Canadian largely as a separate entity, while the cost of a merger with Quebec based Air Canada would be at a heavy employment cost to Western Canada.

One certainty among many uncertainties is that the longer the government insists on remedies that retard the rationalization of the industry and the development of (a) low cost, competitive, national carrier(s), the smaller is the the probability of successful adjustment to the reality of global competition. Much pain in the current economic restructuring in Canada arises from trying to protect too many industries for too long, and saddling them with excessive costs.

Along the way it is important for the travelling public to realize that some of the discount fares offered in the last year will not likely be seen long-term under competition or regulation. The airlines have been desperately trying to minimize losses in the face of a deep and prolonged recession and massive excess aircraft capacity.

Clearly, the real cost to Western Canada, as well as to Canada as a country, is the potential loss of quality jobs. As we noted, because many of Canadian's employees are based in Western Canada, a disproportionate part of the cost will be borne in the west, particularly in Vancouver. Finally, it must not be forgotten that while deregulation has forced change, the current economic problems of the industry are more closely related to the health of the National economy and the changing economics of the industry than they are to deregulation.

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