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Air Canada – From One Crisis to Another

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"The chain of events that brought Air Canada to this crossroads amounts to an almost Biblical litany of woe, a perfect storm of negative news."

- An article on www.globeandmail.com, in April 2003.

TROUBLES, TROUBLES EVERYWHERE!

In early 2003, people in many Asian countries were struck by a mysterious respiratory disease termed as the Severe Acute Respiratory Syndrome (SARS). This highly contagious and potentially fatal disease severely affected the region's economy with the most drastic impact being on the airline industry. As business and commercial passengers cancelled their trips to the Asian countries, airline companies saw their revenues declining at an alarming rate.

Canada's leading air-carrier, Air Canada, was adversely affected by the SARS epidemic. As the news of SARS epidemic reaching Toronto (the company's main hub) spread, Air Canada saw many of its passengers canceling their trips. By March 2003, the world's eleventh largest air-carrier was losing C$5 million[1] per day.

These developments could not have come at a worse time for the company which was already reeling under the pressure of a severe financial crisis. Two factors were responsible for this crisis – Air Canada's merger with the Canadian Airlines and the September 11, 2001, terrorist attacks. After the merger with Canadian Airlines, the company faced many problems such as increased debts, increased employee base and operational inefficiencies. It also suffered a major setback after the September 11, 2001 terrorist attacks in the US, due to the huge drop in air travel worldwide. As a result of these crises, the company posted a loss of US$428 million for 2002.

The severity of the crisis in Air Canada was reflected on its stock price as well. The stock prices had rapidly plummeted through the early 2000s, reaching a 52-week low of US$2.65 by mid-March 2003. Under these circumstances, industry analysts predicted that the airline would in all probability file for bankruptcy protection by the end of the month.

True enough, Air Canada filed for bankruptcy protection under the Companies' Creditors Arrangement Act (CCAA)[2] on April 1, 2003. Robert Milton (Milton), the company's President and CEO, justified this saying, "Clearly, while not our preferred course of action, a CCAA filing is necessary to allow Air Canada to make the required changes to compete effectively and profitably in a changed environment."[3] He further voiced his plans of restructuring the company.

1 June 2003 exchange rate: 1 US $ = 1.3539 Canadian $ (C$).

2 Bankruptcy protection under the CCAA is similar to Chapter 11 bankruptcy protection under the US Bankruptcy Code. It provides debtors a vehicle for operating their business under court protection from the creditors. Under the CCAA, a company might obtain court protection from its creditors for a specific period of time, until it develops and presents a reorganization plan. This plan, aimed at bringing back the company to profitability, needs to be approved by the creditors.

3 'Air Canada to Restructure under CCAA,' www.aeroworldnet.com, April 1, 2003.

Air Canada was required to obtain consent from its creditors, leaseholders and bondholders before restructuring its debt portfolio. However, these stakeholders were reluctant to give their consent unless the employees too agreed to share the losses. Air Canada had already announced plans to cut down its fleet capacity by 15% and lay-off 3,600 employees in March 2003. When rumors of further possible job cuts spread, the company became embroiled in a tussle with its labor unions as well. As uncertainty about the company's future continued, industry observers commented that it would indeed be a shame if the once mighty Air Canada that had survived many earlier crises, were to fail to reorganize itself and become profitable once again.

BACKGROUND NOTE

Air Canada's history dates back to the 1930s, when Canada's airline industry was still in its infancy and only a few regional airlines operated across the country (Refer Exhibit I for a brief note on the Canadian airline industry). During this period, the major player in the airline industry was Western Canadian Airways (WCA), which through the 1920s acquired many regional airways. These regional companies were merged to form Canadian Airways in 1930. However, there still was no national carrier in Canada.

The Canadian government realized the need for a national airline. Consequently, Trans-Canada Airlines (TCA) was legislated as a government owned national airline in April 1936. With a start-up capital of US$5 million and three airplanes, TCA began operations as a subsidiary of the Canadian National Railways (CNR). By 1942, TCA had established a transcontinental route system.

In 1942, Canadian Pacific Railways bought ten small regional airlines and merged them to form Canadian Pacific Airlines (CPA). Though it was primarily a regional player, it plied one transcontinental route as well. In 1945, another new player, Pacific Western Airlines (PWA), began operations in the regional markets. During this period, CPA proposed a merger with TCA. However, the Canadian government rejected the offer, as it did not want to share its control over TCA. Subsequently, the government monopolized international air routes from Canada and declared TCA as Canada's sole transcontinental and international airline.

Over the next two decades, TCA expanded its operations, adding new routes across Asia, Europe and the US. Its growth could largely be attributed to the near absence of competition and the growing consumer demand for airline services post World War II. By now, TCA had also gained reputation as a leading cargo carrier. Meanwhile, through the 1940s, CPA, which did not compete with TCA on the international routes due to government regulations, had acquired permissions to operate in those international routes which TCA did not serve.

During the 1950s, CPA developed an impressive network of international routes. However, it still could not offer transcontinental services, where TCA continued to be a monopoly player. By the late 1950s, CPA and PWA (which had also strongly established itself by acquiring many regional airlines) were posing stiff competition to TCA within Canada. At this point of time, CPA and PWA jointly fought with the government, challenging TCA's monopoly in the transcontinental routes.

After a long tussle with the government, CPA was granted one transcontinental route towards the end of the 1950s. This change in regulation was attributed to the change in power in Canada from the Liberal party to the Progressive Conservative party. TCA now began facing increased competition from CPA on both national and international fronts. At the same time, PWA became increasingly difficult to compete with on the regional front. Meanwhile, TCA changed its name to Air Canada in 1965 to signify that it was not just a national airline, and that it had international and transcontinental operations.

Breaking the company's monopoly even further, the government reformed its regulations in 1967, allowing CPA to operate up to 25% of the total transcontinental routes in North America. In the 1970s, Air Canada took various steps to meet the competition from CPA. It introduced Boeing planes to offer fast, non-stop transcontinental and international services, enhanced its service offerings, and launched the enRoute magazine (1973) to promote the destinations it covered. The magazine also offered corporate news to passengers and informed them of various service improvement initiatives.

In 1977, the government passed the Air Canada Act, which aimed at putting Air Canada on the same footing with the other airlines. Like the other companies, Air Canada was also required to apply for licenses and had to prove its 'necessity and public convenience' to obtain the license. In 1979, the government removed controls on transcontinental routes, throwing the market open for free competition in this arena.

The enhanced thrust on customer service and its promotional initiatives enabled Air Canada to survive the changes taking place in the regulatory framework. It was not only able to retain its leadership in the market, but also emerged as the 10th largest airline in the world (based on number of passenger-miles). In order to leverage the increase in number of air travelers and the frequency of air travel, Air Canada launched its AeroPlan program in 1984. AeroPlan enabled customers to take advantage of their frequent travels as they received various benefits based on their accumulated miles. The program was an instant success[4].

In 1985, the airline industry was deregulated, bringing an end to all the special rights and privileges Air Canada enjoyed as the state-supported airliner. The deregulation was aimed at encouraging free competition in the industry on all routes (domestic, transcontinental and international). In 1986, PWA offered to merge with Air Canada. However, Air Canada was not interested in the proposal. Following this, PWA acquired CPA to form Canadian Airlines International (CAI) in early 1987. In 1989, Air Canada was privatized and freed from government control and the company was listed on the Toronto Stock Exchange. Government restrictions prohibited any single individual or company from owning more than 10% of voting shares in Air Canada.

As industry observers expected, by 1992 Air Canada and CAI were engaged in a severe battle for market share. This eventually resulted in both the airlines losing more than a million dollars a day, as they did not focus on optimizing their operations despite a severe recession in the travel industry (the Gulf war of the early 1990s had resulted in a drastic fall in passenger traffic).

As the intense competition was proving to be detrimental to both the airlines, Air Canada proposed a merger with CAI in 1992. However, CAI rejected the offer. Following this, Air Canada discontinued a major part of its cargo operations and resorted to lay-offs. It eventually returned to profitability by 1995. CAI also obtained cash infusions from the government and US based AMR Corp., the parent company of American Airlines, which helped it tide over the crisis. During the 1990s, Air Canada joined the Star Alliance[5] whereby it entered into mutual service agreements with various international airlines.

In 1998, Milton became the company's President and CEO. Before the company could realize the benefits of its strategies, the company's international operations were struck by the South Asian financial crisis of the late 1990s. As a result, the company posted a substantial decline in its revenues in 1998. However, the airlines managed to survive the depression in the Asian economies

[4] By the end of the century, AeroPlan members accounted for over 50% of Air Canada's traffic and contributed over 60% of its revenues.

[5] Star Alliance is a network of 16 leading international airlines, which came together to offer a unique traveling experience across the world. The Star Alliance partners include Air Canada, ANA, Air New Zealand, Asiana Airlines, BMI British Midland, Austrian Airlines, Lauda Air, Mexicana, Lufthansa, SAS Scandinavian Airlines System, Spanair, Thai Airways International, Singapore Airlines, Tyrolean Airways, Varig Brasil Airlines and United Airlines. Through this alliance, the partners offered access to 700 airports in 128 countries, flexible round the world fares, special frequent flyer plans and a host of other benefits.

without much loss on account of its aggressive marketing initiatives. On account of these strategies Air Canada also succeeded in eating into CAI's market share. By now, CAI, unable to steer itself through the Asian financial crisis and meet the competition posed by Air Canada, was on the verge of bankruptcy (with debts over US$3 billion).

AIR CANADA, CAI & ONEX – THE TAKEOVER DRAMA

Air Canada offered to buy CAI's international business in August 1999. In the same month, Onex Corp. (Onex[6]), along with its strategic partner American Airlines, offered to buy both Air Canada and CAI for US$1.8 billion and then merge the two airlines. Onex offered to pay US$8.25 for every Air Canada share and US$2 for every CAI share. CAI readily accepted the offer since Onex was ready to assume its US$3.9 billion debt as well. However, Air Canada categorically stated that it was not interested in such an unsolicited offer. It further stated that the price offered was insufficient as it was below the market value of its shares (US$8.70 per share).

Air Canada also accused Onex of attempting a hostile takeover. Following this, Air Canada increased the number of its outstanding shares through a shareholders rights plan, effectively doubling the price of any takeover offer. Air Canada also scheduled a special shareholders meeting to discuss Onex's offer on January 7, 2000.

Onex considered Air Canada's actions 'disrespectful and arrogant'[7] and took legal action against it, demanding that the meeting be rescheduled to an earlier date. In September 1999, the court ordered Air Canada to reschedule the shareholder's meeting to November 8, 1999. Much before the meeting could be held Air Canada announced its financial results for 1999. The company planned to use its strong performance as reflected in the financials to encourage the shareholders to reject Onex's offer.

Onex then tried to buy Air Canada shares by paying its shareholders a premium over the market price. Air Canada in turn announced a buy back, matching Onex's offer. This price bidding war resulted in the offer price touching US$17.50 by November 2000. Meanwhile, Air Canada approached the court accusing Onex of trying to violate a shareholding rule of Air Canada, which stated that no single shareholder could hold more than 10% of the company's shares. At the same time, Air Canada made a counter offer to buy CAI for US$92 million. Once again, CAI turned down the offer. In November 2000, the court ruled that Onex could not buy more than 10% shares in Air Canada. As Onex saw its chances of acquiring Air Canada being ruled out, it withdrew the offer.

As the government did not want CAI to go bankrupt, it reportedly urged Air Canada to acquire the company. Following this, Air Canada once again offered to buy CAI for US$92 million and proposed to operate the latter as a separate airline. However, CAI announced that it would explore other avenues before it considered Air Canada's offer. Reportedly, CAI was trying to acquire funds and was contemplating various alternatives to restructure its operations. Meanwhile Air Canada dropped its idea of acquiring CAI and instead proposed a merger with the latter. As CAI failed to acquire funds, to restructure its business, from other sources, it finally agreed to merge with Air Canada in December 1999. Commenting on the merger, Milton said, "We did not start this process, but we are willing to fix the situation by taking Canadian Airlines under our wing and making that airline achieve what it is capable of achieving."[8]

Air Canada had to assume more than US$3 billion of CAI's debt, take the burden of CAI's restructuring, and agree to honor its employment agreements. The deal, expected to be completed by mid-2000, gave Air Canada 80% share of the domestic market. Analysts commented that Air

6 Canada based Onex is a diversified company with interests in the electronics manufacturing services, customer management services, automotive products, engineered building products, communications infrastructure, and sugar refining and marketing businesses (2002 revenues US$ 23 billion).

7 The Onex Proposal, www.cbc.ca.

8 www.aircanada.ca, August 10, 2000.

Canada's near monopoly status in the industry could help it force competitors out of the market and exploit the customers. To address this concern, the government imposed strict regulations on the operations of Air Canada. Air Canada was required to keep prices at their existing levels to ensure that it did not exploit its leadership position. The company was also not allowed to reduce prices below cost in order to undersell other airlines in the regional and transcontinental routes.

MERGER TRAUMAS

In the months following the merger with CAI, Air Canada faced a host of problems on the employee, customer and strategic fronts. The merger resulted in the addition of 16,000 employees of CAI to Air Canada's employee base. Of its 40,000 employee base, around 10,000 were surplus (on account of duplicate positions). However, the company could not lay off the excess workforce due to the terms of the merger agreement.

All along, trade unions of both the companies had expressed their displeasure over the deal, fearing lay-offs and wage cuts. Analysts too felt that as the two airlines had been bitter competitors for many decades, it would prove to be very difficult for the respective workforces to establish harmonious working relationships. Reportedly, unions of each company wanted a majority of job cuts to fall on the employees of the other company. Some Air Canada employees were afraid that as most of them had less seniority than CAI employees, they might be forced to take the majority share of job cuts.

Analysts claimed that Milton, who was just 39 and not a very experienced leader, was not able to handle the above issues properly. The government and Milton were severely criticized for forcing together people from two entirely different and rival work cultures. Some Air Canada employees also blamed Milton's management style for the crisis at the company. Reportedly, Milton's relationship with the employee unions in Air Canada had been rocky ever since the merger took place. A few employees even referred to Milton as 'arrogant, insensitive and unable to deal with passengers, the government and employees'.[9]

Even as Air Canada was finalizing the CAI deal, it realized that the Canadian airline industry was changing rapidly with the entry of many new airlines in the regional routes. The existing regional airlines were also looking towards consolidations and realignments. To deal with the above issues and to fully synergize the merger, Air Canada announced a comprehensive restructuring exercise in early 2000. The program aimed at cutting costs, improving operations and services, and restructuring CAI's debt. The above initiatives were also necessitated by the fact that the company wanted to eliminate any duplication of services.

As part of eliminating duplication, Air Canada cut down 20% of its combined fleet. As a result, many customers, particularly those on regional routes which were served only by Air Canada, complained of the inadequacy of flights and said that they found it difficult to travel in and out of those places when required.

Air Canada was also criticized for its poor services post merger. Many customers complained of the long queues at Air Canada ticket counters and the poor ticket reservation service they received when booking tickets over the phone. Delays in flight schedules and the deteriorating service on flights added to the woes of the customers. Analysts attributed the above problems to the rivalry between the work forces of Air Canada and CAI. Integration of the two work forces had been problematic since the beginning. The animosity between the work forces of both the airlines and their anger at the management for forcing them into such a situation adversely reflected on their performance, leading to a sharp decline in the quality of service.

9 www.sympatico.workopolis.com, 'Milton Faces Fight-or-Flight Dilemma,' April 5, 2003.

Other regional airlines were quick to cash in on Air Canada's problems. By offering better services, they began weaning away its customers. To arrest the customer exodus and address customer complaints, the company announced a 180-day service improvement plan in June 2000. It hired 2,000 new workers to help improve customer services, shortened the lines at check-in counters, ensured that the flights met specified time schedules and reduced the waiting time of passengers booking their reservations over phone by 80%. In November 2000, the company announced that it had achieved the objectives of its plan. Commenting on this, Milton said, "Customers who have flown with us recently have had a markedly different travel experience."[10]

As a part of the restructuring exercise, Air Canada reorganized its AeroPlan frequent flyer unit into a separate profit center in mid-2000. Commenting on this, Calin Rovinescu (Rovinescu), Executive Vice President (Corporate Development and Strategy) said, "The new division will focus on leveraging the program's enormous potential through dedicated management and staff resources. Our objective is to structure AeroPlan in a more efficient and focused manner in order to further improve the quality of the program's customer service levels and incentives, and to increase and further leverage our commercial partnerships."[11]

Following this, through the mid 2000s, the company took various steps to expand its AeroPlan partner base, to expand into new consumer areas, and to derive the benefits of e-commerce. Despite all the above, Air Canada showed only a marginal increase in its customer base. This was because of Air Canada's high prices as compared to that of the regional airlines. This was in turn attributed to the company's high operating costs as it offered multiple frills (variety of services offered to customers such as different types of meals, , baggage handling, etc.).

The other initiatives taken by the company included integrating route networks and schedules of the two airlines, combining their passenger and cargo operations and administration and marketing functions. Though company sources said that the restructuring objectives had been achieved, the economic recession that began towards the end of 2000, severely affected its financial performance. As a result, Air Canada could not realize the benefits of its restructuring exercise.

By early 2001, the beleaguered company found itself combating another crisis – the growing presence of discount airlines[12] such as Canada 3000 and WestJet. These airlines, with their no frills regional services, offered air travel at much lower prices as compared to Air Canada. In early 2001, Canada 3000 acquired Royal Airlines and Canjet, two leading regional airlines. Following these acquisitions, it emerged as the second largest airline in Canada, serving many international routes as well. Thus it became a major force to be reckoned with in the Canadian airline industry.

Air Canada decided to take proactive measures to survive the economic downturn and return to profitability. These measures included cutting costs and leveraging on the synergies of the CAI deal (the chance of tapping new regional and international routes). The company expected to save US$700 million through these initiatives. For July and August 2001, Air Canada reported a combined operating income of US$81 million. Analysts believed that if the company managed to sustain this momentum, it could return to profitability in fiscal 2001.

It was however, time for Air Canada to face the next crisis – the September 11, 2001 terrorists' attacks in the US. The terrorist attacks scared the passengers away from air travel, nearly leaving the airports empty and leading to an acute fall in revenues of airlines worldwide. According to the International Air Transport Association, the economic cost to the global airline industry amounted to C$15 billion by September 17, 2001. These developments nullified Air Canada's efforts to improve its position. The company reported a pretax loss of C$160 million for the third quarter in 2001.

10 www.cbc.news.com, December 8, 2000.

11 www.aircanada.ca, August 10, 2000.

12 A discount airline is (generally) a domestic airline that offers lower prices for passengers who are looking for basic transportation (no frills service) between major cities within a country.

RESTRUCTURING: POST-SEPTEMBER 2001

Air Canada resorted to massive capacity cuts and job cuts to reduce its costs and survive the crisis. Under its capacity cut initiatives, it cut its flight schedules by 20% by removing 84 flights from its fleet and discontinued services on some unprofitable routes. In 2001, Air Canada laid off around 9,000 employees.[13]

In late October 2001, the company announced a complete restructuring plan that involved transformation of every facet of its operations viz. markets, services, costs, pricing and technology. The new restructuring plan was based on four principles: market segmentation and re-branding, technology and distribution, exploitation of ancillary businesses as profit centers, and process redesigns and cost cuts.

The reduction in its fleet in some routes after taking over CAI was not the only reason for this. Analysts attributed the problem to the company's inability to understand the changing preferences of the customers and the shifting dynamics of the industry. As more players (especially discount airlines) entered the market, air travelers had become increasingly price conscious.

In these circumstances, Air Canada realized that running a full service airline was no more a viable option. Hence in late 2001, Air Canada announced plans to launch sub-brands to meet the changing requirements of its customers. Commenting on this, Rovinescu said that Air Canada decided, "To provide self-service where the customer wants self-service. To provide lounges, concierge services, multiple frequencies and refundable tickets only where the customer is willing to pay for them. To provide connectivity and interline services only where required."[14] In line with the above decision, the company soon launched many sub-brands (Refer Table I).

Table I: Air Canada – Sub Brands

Tango: Launched in November 2001, Tango was an independent, low fare brand of Air Canada. It offered services to Toronto, Calgary, Edmonton, Fredericton, Halifax, Montreal, Ottawa, Quebec City, Saint John, St. John's, Vancouver, and Winnipeg. An airline within an airline, it gave consumers a no-frills air travel alternative to Air Canada's full service operations. Tango offered all the benefits of a no-frills carrier viz. on-line booking (paperless ticketing), affordable pricing, and simple food service. Tango was an instant success, crossing the one million-customer mark by May 2002.

Jetz: Launched in early 2002, Air Canada Jetz was a jet charter service offering a premium business service for corporate groups, sports teams, rock bands etc.

Jazz: Launched in early 2002, Jazz was formed by merging four regional airlines of Air Canada, AirBC, Air Ontario, Air Nova, and Canadian Regional. It operated as a wholly owned subsidiary of Air Canada with its own fleet, headquarters, and management team. Jazz soon emerged as one of the world's largest regional airlines, serving 80 destinations in Canada and the US, and providing Air Canada customers with seamless connections to the worldwide networks of Air Canada and the Star Alliance.

ZIP: Launched in September 2002, ZIP was aimed at customers who demanded more options in low fare, high value air service. It was incorporated as a separate entity Zip Air Inc., with ZIP as the trademark. ZIP operated mainly on short haul routes, with services between Edmonton, Vancouver, Calgary, and Winnipeg. There were plans to extend it to other parts of Canada and the US in the future.

Source: www.aircanada.com

[13] As per the take-over agreement, Air Canada could not lay off employees before March 1, 2002. During mid 2001, Air Canada laid off up to 4,000 employees by urging them to take voluntary retirements and labor-hour cuts. After the September 11 problem, as the employees were not ready to take voluntary cuts, Air Canada sought government help. The government approved the lay-offs stating the circumstances as exceptional.

[14] www.aircanada.com, October 22, 2002.

According to company sources, this sub-branding initiative helped Air Canada meet the requirements of various customer segments. Apart from helping the company counter the competition from discount airlines, the move was expected to help it increase its customer base.

Next on Air Canada's restructuring agenda was pruning distribution costs, including travel agents, credit card fees, call centers, and customer relation services that exceeded US$1.5 billion. The company decided to increase the usage of Internet in its distribution activities. In line with these strategies, it made the Internet a central component in the operation and management of its new sub-brands.

Commenting on this, Rovinescu said, "Dealing directly with our customers online, allows us to greatly simplify our pricing and our ticketing while improving the customer relationship through more personalized service, which in turn drives loyalty."[15] On account of its Internet initiatives, Air Canada's online distribution increased to 15% of its total distribution, as compared to 4% earlier. Reportedly, by the late 2002, more than 80% of Tango's bookings were being made online.

In April 2002, Air Canada launched an Internet travel services portal, Destina.ca, which offered comprehensive information on travel destinations across the world. Destina.ca offered large discounts on airfares and provided access to 53,000 hotels and 52 car rental agencies and also provided AeroPlan miles (points). Destina.ca attracted more than a million visitors with the first two months of its launch and soon became one of Canada's most popular online travel portals. As Destina.ca offered booking services and travel information online, it considerably reduced the customer service and ticket distribution costs for Air Canada.

The company embarked on a cost reduction and process redesign drive by motivating employees to increase productivity, reducing unit costs, and shrinking airline capacity. The introduction of short distance flights with low capacity and low operational cost helped in cost reduction (5% reduction in its unit costs and over 10% improvement in employee productivity).

Air Canada decided to exploit the success and popularity of its AeroPlan division and Air Canada Technical Services division (responsible for the maintenance, overhaul, and repair of its fleet). It planned to float these as separate companies by early 2003. By mid-2002, AeroPlan had more than six million members (one-fifth of Canada's total population) and generated revenues of US$325 million in 2001. AeroPlan continued to expand its partner network by building on existing partnerships in travel, entertainment and financial credit card sectors and by entering into new partnerships to increase customer service categories and promote e-commerce.

Air Canada also decided to leverage the success of its Technical Services group by floating it as a separate company in 2003. The group was operating as an independent profit center of Air Canada and was also offering its expertise to other airlines. Its third party revenues exceeded US$220 million in 2001.

By late 2002, Air Canada was offering scheduled and charter air transport (for both cargo and passengers flights) to more than 150 destinations. In addition, it was also offering vacation packages to more than 90 destinations across the world. By 2002, Air Canada also earned the distinction of being the world's safest airline and in 2002, was voted the best airline in North America for the second time in three years. During the same period, Aeroplan was also voted the best frequent flyer plan in the world.

Industry observers felt that the company had left the worst behind and could now look forward to a profitable period. However, they were soon to be proved wrong. Due to problems inherent to its near monopoly status, tightened regulatory setup, and some of its newly-implemented strategic moves proving counter-productive, Air Canada soon found itself once again mired in problems.

[15] www.aircanada.com, October 22, 2002.

THE BAD TIMES CONTINUE

According to analysts, airlines in Canada were overburdened with the amount of tax they were required to pay to the government. As revenues fell after the US terrorist attacks, it had become nearly impossible for airlines in the country to remain viable business ventures after paying such high taxes. Many of the players went bankrupt, leaving Air Canada with 85% of the marketshare. WestJet was the second largest player (WestJet had managed to remain profitable on account of its small, low cost, regional operations). Being the largest player, Air Canada was hit the hardest by the unfavorable tax-regime.

Air Canada's coverage and size of operations had expanded significantly after it launched its sub-brands in 2002. This, in turn, meant that the company had to pay higher taxes to the government and the airports (mainly fuel excise taxes, air navigation taxes, airport improvement taxes, and air security surcharge). In late 2002, the Canadian government increased the airport improvement fees by 50%. During the same period, it also increased the airport security surcharge (for domestic flights) and air navigation charges.

The increase in taxes naturally increased the financial burden of the airline companies. Commenting on the scenario, Rovinescu said, "While we are turning the organization inside out to save costs, looking for every dollar, we are facing a seemingly endless and irresponsible escalation in costs passed on by the government and the government-mandated monopolies, such as airports."[16] Air Canada apparently had no option but to pass on the cost increases to its customers in the form of increased fares, which turned away passengers from the airline. As a result, passenger revenues, already at all-time lows (the September 11 after-effect), further declined. The combined effect of the tax issue and fare hike resulted in the company losing US$1.25 billion in fiscal 2002 (Refer Exhibits II, III & IV for Air Canada's financials).

In March 2003, the Office of the Superintendent of Financial Institutions (OSFI)[17] ordered Air Canada to cover its employee pensions fully, as it discovered that the company's employee pensions were not covered completely. This further added to the financial burden of the company.

Meanwhile, the restrictions imposed by the government to ensure Air Canada did not misuse its monopoly position, continued to hamper its growth. Added to this, the combined effect of the CAI debt burden, expenditure incurred in launching the sub-brands (fleet purchasing/leasing) and the SARS epidemic drove the company down. In early 2003, Air Canada, with a debt of C$11 billion, filed for bankruptcy protection.

WILL THE PROBLEMS EVER END?

In April 2003, Air Canada announced a restructuring exercise under CCAA to reduce its debt and return to profitability (Refer Exhibit V for details of the restructuring plan). As Air Canada's creditors were not ready to discuss any debt restructuring plans unless its employees agreed to share the burden, agreement of unions to labor and cost cuts was essential. The company thus initiated discussions with its nine employee unions to get their consent for lay-offs, wage cuts, and elimination of a few employee benefits. According to company sources, Air Canada needed to cut over US$560 million from its annual labor costs of US$2.2 billion and lay off up to 10,000 employees.

By June 2003, Air Canada succeeded in persuading its employee unions to lay-offs and wage cuts that would save US$804 million in labor costs, to the company. However, the agreements with the employee unions were tentative and the unions were required to ratify these agreements by June

[16] www.aircanada.com, October 22, 2002.

[17] OSFI monitors pension funds for private companies operating in government-regulated markets such as the airlines industry in Canada.

30th 2003.[18] Air Canada was preparing to present its debt-restructuring proposal before its creditors and other stakeholders in late June 2003. According to reports, the plan was to restructure its US$8.8 billion debt by converting a part of the debt and claims (US$6.5 billion) into stock and by negotiating for few relaxations in leaseholder agreements. However, analysts were quick to point that Air Canada had very little to offer its bondholders and suppliers and they would end up with a very small percent of the actual amount that Air Canada owed them.

However, in the light of employee unions supporting the restructuring plans, the company seemed to be in a good bargaining position with its creditors and stakeholders. Commenting on this, Dale Doreen, Director, International Center for Aviation Management, Concordia University (Montreal) said "If they go bankrupt, (creditors) get nothing because probably there is not a lot of assets left, so I think it will be in the interest of creditors to keep Air Canada going and possibly earn some money to pay them back."[19] The company's board was also confident that it could convince the creditors and other stakeholders to agree to the restructuring plan.

This uncertainty about its future soon took a toll on Air Canada's business. While many members of the AeroPlan expressed concern about their frequent-flyer points, many customers had reportedly started booking their tickets with other airlines. Some AeroPlan partners even planned to sever their ties with Air Canada. In order to retain its customer base, Air Canada reduced its fares for domestic travel and also eased certain restrictions (regarding cancellations and booking changes). To further convince customers about its future prospects, it released a press statement after it reached an agreement with the unions, "It is business as usual for Air Canada and customers may book with confidence."[20]

Although Air Canada had adopted various initiatives to get back on track, many of the issues that had led it towards bankruptcy were still present. Till June 2003, the airline industry had been unsuccessful in persuading the Canadian government to reduce the tax burden. The merger related problems, the overall downturn in the global aviation industry, and the global recession were expected to continue plaguing Air Canada. And nobody could rule out the possibility of future mishaps such as terrorist attacks and epidemics. For now, the only solace to Air Canada was that it was doing its best to restructure itself, and trying to regain the glory that it had lost a long time ago.

QUESTIONS FOR DISCUSSION:

1. Examine the factors that helped Air Canada become the world's 10th largest airline by the 1990s. Critically comment on the role played by the government in the company's development over the decades. Did the government support harm the company in any way?
2. Analyze the circumstances under which Air Canada merged with CAI. Discuss the problems faced by the company after the above deal and comment on the reasons behind them. What steps did Air Canada take to overcome these problems and how far did these measures prove effective?
3. Discuss the various external problems faced by Air Canada including the September 11, 2001 crisis. Examine and evaluate the initiatives taken by the airline to overcome the various crises it faced. What were the other factors that drove Air Canada into seeking bankruptcy protection in 2003? Comment on the company's future in the light of its new restructuring plan and its continuing problems. Suggest some possible measures to help Air Canada return to profitability.

[18] On June 2, 2003, as Air Canada closed its deals with all its employee unions, its shares gained 25 Canadian cents, closing at C$1.92.

[19] www.reuters.com, 'Air Canada Stock Soars After 11th Hour Pilots Deal,' June 2, 2003.

[20] www.forbes.com, 'Air Canada Pilots Bow to Cost-Cutting Deal,' June 1, 2003.

Exhibit I

A Brief Note on the Canadian Airline Industry

Till 1987, the Canadian airline industry was regulated by the Canadian Transportation Agency, which had the power to license and impose specific conditions on airlines. After the deregulation in 1987, the airline industry was governed under the rules of the National Transportation Act. Flight services offered by airlines in Canada included regular and chartered flights, cargo services, and jet services. Competition in the industry was governed by the Competition Act, a federal law that governs business in Canada, covering all criminal offences and civil law matters. Criminal offences mainly include misleading advertisements and price-fixing conspiracies. The civil matters include mergers and acquisitions, abuse of dominant position, refusal to deal and exclusive dealings. The Competition Act aimed at ensuring healthy competition as a part of which it did not allow merger of airlines when such a merger was suspected to lessen the competition in the industry by resulting in the emergence of a dominant player.

With the deregulation of the airline industry in 1987 and with the emergence of Canadian Airlines International (CAI), formed by the consolidation of CPA, PWA, and other few regional airlines, as a national carrier competing directly with Air Canada, the competition in the industry intensified. As the Canadian airline market remained a closed model, where the entry of foreign players was restricted to only 25% of the industry, the competition was mainly between Air Canada and CAI. The two airlines jointly controlled over 80% share of the domestic market in Canada, while the regional airlines were left with the remaining marketshare, with each regional airline serving its niche market.

The number of regional airlines increased through the late 1980s. By the late 1990s, major regional airlines in Canada included Air BC, CanJet, Royal Airlines, Air Ontario, Air Nova, Canada 3000, Air Alliance, WestJet and Canadian Regional Airlines. However, the economic recession during the late 1990s, severely hit the industry, following which, in August 1999, the government relaxed the competition rules for 90 days to allow the airlines to merge and restructure themselves to survive the crisis. Following this, Air Canada acquired CAI and emerged as the sole national carrier in the country.

In 2001, Canada 3000 emerged as the second leading player in the industry by acquiring Royal Airlines and CanJet. Next was WestJet, which emerged as the most profitable regional airline. By 2001, the airline industry was generating annual revenues of more than US$14 billion and employing more than 90,000 people. During this period, there were 885 licensed air carriers, of which 41 airlines were rated as chief airlines as they annually transported a minimum of one million passengers (through regular or chartered flights) or 20,000 tons of goods (cargo).

The September 11, 2001 crisis severely affected the airline industry worldwide. Increased fuel prices and airlines related taxes in 2002, followed by the Iraq war and the SARS epidemic caused severe financial crunch in the global airline industry by early 2003. During the same period, Air Canada remained the leading player in the market despite acquiring creditor protection under CCAA. It was followed by WestJet, which operated discount airlines in Western Canada. Other major players operating in various niche markets included Air Labrador, Air Transat, Air North, Central Mountain Air, Air Inuit, Provincial Airlines, Pacific Coastal Airlines, North Vancouver Air, and West Coast Air.

Compiled from various sources.

Exhibit II

Air Canada – Financial Statements (2001-2002)

(in US$ million)

Year Ended December 31	**2001**	**2002**
Operating Revenues:		
Passenger	8,123	8,190
Cargo	578	585
Other	910	1,051
	9,611	**9,826**
Operating Expenses:		
Salaries and Wages	2,495	2,492
Benefits	527	607
Aircraft Fuel	1,593	1,288
Depreciation, Amortization and Obsolescence	441	372
Commission	476	369
Food, Beverages and Supplies	435	395
Aircraft Maintenance, Materials and Supplies	569	508
Airport and Navigation Fees	738	772
Aircraft Rent	959	1,109
Other	2,109	2,106
	10,342	**10,018**
Operating Loss Before the Under-Noted Item	(731)	(192)
Non-Recurring Labor Expenses	-	26
Operating Loss	**(731)**	**(218)**
Non-Operating Income (Expense)		
Net Interest Expense	(275)	(221)
Loss on Sale of Assets	(85)	(42)
Others	126	97
	(234)	**(166)**
Loss Before Foreign Exchange on Long-Term Monetary Items and Income Taxes	(965)	(384)
Foreign Exchange on Long-Term Monetary Items	(20)	(60)
Loss Before Income Taxes	(985)	(444)
Provision for Income Taxes	(330)	(384)
Loss for the Year	**(1,315)**	**(828)**

Source: Air Canada Annual Report 2002.

Exhibit III

Air Canada Balance Sheet (2001-2002)

(in US$ million)

Year Ended December 31	**2001**	**2002**
Assets		
Cash and Cash Equivalents	1,067	558
Accounts Receivable	764	760
Spare Parts, Materials and Supplies	344	367
Prepaid Expenses	60	86
	2,235	**1,771**
Property and Equipment	2,830	2,279
Future Income Taxes	404	4
Deferred Charges	1,619	1,781
Goodwill	510	510
Other Assets	1,146	1,071
	8,744	**7,416**
Liabilities		
Accounts Payable and Accrued Liabilities	1,857	1,713
Advance Ticket Sales	481	506
Current Portion of Long-Term Debt and Capital Lease Obligations	531	373
	2,869	**2,592**
Long-Term and Subordinated perpetual debt and capital lease obligations	4,580	4,314
Future Income Taxes	60	32
Other Long-Term Liabilities	1,279	1,405
Deferred Credits	1,416	1,361
	10,204	**9,704**
SHAREHOLDER'S EQUITY		
Share Capital and Other Equity	977	977
Contributed Surplus	15	15
Deficit	(2,452)	(3,280)
	(1,460	(2,288)
	8,744	**7,416**

Source: Air Canada Annual Report 2002.

Exhibit IV

Air Canada – Key Statistics (1998-2002)

	1998	1999	2000	2001	2002
Operating Income (Loss) ($M)[1]	95	377	83	(731)	(281)
Operating Margin (%)	1.6	5.9	0.9	(7.6)	(2.2)
EBITDAR ($M)[2]	861	1,201	1,204	669	1,263
Aircraft Fuel Prices (Cents)[3]	26.3	24.6	38.0	38.9	33.7
Cash Flows from (used for) Operations ($M)	284	680	140	(1,072)	(95)

Source: Air Canada Annual Report 2002.

1. $M = $ Million
2. EBITDAR = Earnings Before Income Tax, Depreciation, Amortization, and Aircraft Rent.
3. Fuel Price per Litre.

Exhibit V

Restructuring of Air Canada under CCAA

The restructuring of Air Canada under CCAA was aimed at reducing its debt and restructuring its businesses. The plan was divided into three parts: commercial restructuring, operational restructuring and corporate restructuring.

Commercial Restructuring:

- Simplify pricing.
- Restructure the network to enable greater ease of use through increased frequency and connecting opportunities.
- Adjust flight capacity on the basis of customer demand.

Operational Restructuring: Fleet

- Eliminate smaller fleet such as Boeing 737- 200, Boeing 747- 400, and BAE 146.
- Increase the CRJ-50 fleet.
- Introduce regional jet aircraft (with a capacity of 90 seats).

Corporate Restructuring:

- Focus on developing profitable, stand alone businesses.
- Separate regulated operations from non-regulated businesses and align management and labor interests.
- Create a new holding parent corporation, Air Canada Enterprises, with independent business units for every business activity Air Canada is involved in.
- Continue to carry on domestic, trans-border, and international airline business as Canada's national carrier.
- Reorganize Air Canada's equity interests in its subsidiaries: Jazz, AeroPlan, ZIP, Air Canada Technical Services, Air Canada Capital, Air Canada Vacations, and Destina.ca will be directly owned, as sister companies by Air Canada Enterprises.
- Create Airport Ground Handling, to operate as a subsidiary of Air Canada Enterprises.
- Make Air Canada Cargo business operations a subsidiary of Air Canada Enterprises.

According to Air Canada executives, the restructuring exercise was expected to enhance the operational and financial flexibility of Air Canada, enabling it to pay back its debts and return to profitability.

Source: www.aeroworldnet.com, Air Canada to Restructure Under CCAA, April 1, 2003.

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2. Vivendi Universal: In a Strategic Flux, Reference No: 303-160-1
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