



This New Law Is Very Bad News for Air Canada and WestJet Airlines Ltd.

Description

Shares of both **Air Canada** ([TSX:AC](#))(TSX:AC.B) and **WestJet Airlines Ltd.** (TSX:WJA) traded lower on Thursday. Air Canada shares fell 3.2%, while WestJet shares did a little better, only declining 1.5%. Air Canada shares recovered on Friday, while WestJet continued to plunge, falling an additional 2.4%.

Both airlines were hit by the same piece of news. Federal transport minister Marc Garneau announced on Thursday that his Liberal government will sponsor a bill that would ease foreign ownership restrictions from 25% to 49% of domestic airlines—a decision many feel paves the way for the creation of new ultra-low-cost carriers.

Garneau also announced he would allow two new upstart airlines—Canada Jetlines Ltd. and Enerjet—to immediately gain access to the new ownership rules, provided no single investor owns more than 25% of the airline.

This is very good news for Enerjet. It took the opportunity to announce it would be partnering with Indigo Partners, which has invested in many of the leading ultra-low-cost carriers, including **Spirit Airlines**.

Indigo's interest isn't the only reason Enerjet is feeling optimistic. The company already has an operating certificate for its charter service. Darcy Morgan, Enerjet's chief commercial officer, told *The Financial Post*, "I'd like to think we're probably 18 months ahead of anyone who would be starting from scratch." Enerjet still hasn't estimated when it will start to fly, however.

Jetlines estimated it would start flying sometime in the summer of 2017.

It's obvious such news is negative for Canada's incumbent airlines. The only question is, how bad will it be?

The bull scenario

Both Air Canada and WestJet have faced significant competition over the years. Each time the two incumbents have emerged victorious.

It's hard to start up a new airline. The usual method is to compete on price, offering ticket prices that are very enticing. Planes fill up, but these customers aren't profitable.

One way new airlines will try to get market share is to focus on smaller airports with much lower fees. Instead of flying to Toronto, they'll fly to Hamilton. Instead of Vancouver, they'll choose Abbotsford. Calgary will be eschewed for Edmonton. And so on.

While this helps keep fares down, it's annoying for most customers. The average business traveler isn't going to take a sub-optimal route to save a couple hundred dollars. Recreational travelers might be more inclined to do so, but many of us will just suck it up and pay the extra to go the route or time we want.

In short, the bull scenario comes down to this: both Air Canada and WestJet are firmly entrenched and can handle a challenge from a new upstart airline. It's tough to compete against two companies that dominate the skies.

The bear scenario

The bear scenario is easy to identify too. Canadians are tired of paying what many view as excessive fees to get from place to place. A model that's dedicated to saving us money will be popular.

Ultra-low-cost carriers realize there isn't much difference between different airlines. Price is what matters. Since every decision is made with that in mind, it's easy for these carriers to have a lower cost than the two incumbents.

This advantage carries over no matter where they fly. Once an ultra-low-cost carrier has a little success flying to secondary markets, they can expand to bigger airports. They can pay the airport fees and still undercut WestJet and Air Canada, who many accuse of colluding to keep prices high.

The last thing airlines want is a price war. One of the reasons why the last few years have been relatively calm for the industry is both of the major players have kept prices high. Any force that brings prices down is bad news.

The bottom line

There's a reason why one piece of news sent airline investors scrambling for the exits. It's obvious the government is trying to increase competition. That's ultimately bad news for the two dominant players, but investors shouldn't panic yet. It's still going to be very tough for a new competitor to be nothing more than a nuisance.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)

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