Issue no. 239
September 2018

Brexit: Tension mounts but no panic (as yet)

As described in previous *Aviation Strategy* articles, Brexit raises numerous complex issues for air transport. Aviation has its own, unique international regulatory regime, distinct from World Trade Organisation rules, is highly regulated at several levels and attracts more than its fair share of public attention. It is little wonder that there is such confusion and gloom when it comes to one of the most important negotiations the industry has faced for a long time.

Michael O'Leary of Ryanair has been particularly pessimistic about the post-Brexit future. In an interview with CNN in March, for example, he again stressed the risk of all flights between the UK and the rest of Europe being grounded from next spring. "*Six months before Brexit is when the airlines will really be panicking and customers will... [be asking] 'Are these flights going to operate?*"'

This certainly isn't the first dire warning from O'Leary about Brexit. As long ago as August 2017, he threatened to take flights off sale in September 2018 if an open skies deal wasn't agreed between the UK and EU. Three months earlier he had advised British holiday-makers to get used to travelling by boat as there was a real risk that Brexit could shut down all flights to and from the UK. Yet this month Ryanair, far from closing down sales to and from the UK, announced that it was adding 23 new routes to its London schedule for summer 2019, including 14 from a new base at Southend.

We are now some six months away from Brexit Day, 29 March 2019. Is there any sign of panic among aviation stakeholders, or should we take O'Leary's warning with another large pinch of salt? The answer is far from clear. Fundamentally there is still every reason to believe that acceptable aviation deals covering safety regulation and airline market access will be achievable in time. Probably, as explained below, these deals will replicate much of the regulatory arrangements currently in place, and everyone will be asking: "What was the problem?"

However, at the same time there are certainly signs of some panic as Brexit Day gets closer, especially with respect to safety regulation. This affects all aspects of aviation, but particularly manufacturing. The problem is not that agreement on a deal has become any more difficult in itself. Rather it reflects a lack of flexibility on the part of the European Commission that is preventing critical preparatory work being undertaken. There is consensus that to arrive at Brexit Day with no deal *and* no preparation would be a disaster.

The timetable for the broader Brexit negotiations over the next few months includes a series of EU summits on 20 September, 18 October, probably the week beginning 12 November and finally 13 December. No agreement was reached in September, as had originally been hoped, and November now looks like a more likely date. The final deadline is 13 December if an agreement is to be ratified in time by the UK and EU Parliaments. In addition, there remains significant doubt on whether any deal can attract sufficient political support in the UK.

So a No Deal outcome is still possible. Nathalie Loiseau, the French minister for European Affairs, perhaps taking the lead from Michael O'Leary's approach to Brexit, recently warned that in such circumstances the French Government would block all flights from the UK, which seems extreme to say the least, even accepting that the parties are still in the middle of a lengthy and difficult negotiation. The UK Government "*acknowledged that planes would be grounded without a post-Brexit agreement*," but that is not quite the same as saying that *all* flights would be stopped. Most commentators believe that old bilateral air services agreements between the UK and individual EU States would at least

This issue includes

Aviation Strategy

ISSN 2041-4021 (Online)

This newsletter is published ten times a year by Aviation Strategy Limited Jan/Feb and Jul/Aug usually appear as combined issues. Our editorial policy is to analyse and cover contemporary aviation issues and airline strategies in a clear, original and objective manner. Aviation Strategy does not shy away from critical analysis, and takes a global perspective — with balanced coverage of the European, American and Asian markets.

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ISSN 2041-4021 (Online)

protect most third/fourth freedom operations. Nevertheless, it is clear that the stakes are high and the pressure is mounting.

Safety Regulation

The UK CAA has stated publicly that it would not be in a position for some time to take on all the safety regulation responsibilities currently performed by the European Aviation Safety Agency. It is vital, therefore, that some way is found to ensure that such regulation is carried out effectively and legally. By far the best way of doing this would be for the UK to remain a participant in EASA. This is in everyone's interests, including the EU/27 (and indeed the wider aviation industry beyond the EU), not least because the UK is at present the largest contributor of manpower and finance to EASA.

Since EASA is an EU agency, formal membership is open only to EU Member States, but there are ample precedents for non-Member States to become Associate Members. There were thought to be two problems with this approach from a UK perspective. First, EASA will continue to be subject to the jurisdiction of the European Court of Justice, which was a red line for many UK supporters of Brexit. Secondly, Associate Members of EASA can participate in meetings and discussions, but formally do not have a vote on decisions.

However, votes are actually quite rare in the organisation, which tends to reach agreement by consensus among technical staff. In March, the UK Government announced that despite the problems outlined above, it was prepared to accept, and pay for, Associate Membership. This was certainly an enormous relief to aviation stakeholders.

There is no obvious reason why the EU should reject a UK application for Associate Membership of EASA, at least in normal circumstances. It has welcomed several other third countries to join on such terms. The expectation after the Prime Minister's proposal, therefore, was that once agreement had been reached on a broad Brexit deal, arrangements would quickly be put in place to ensure that something very close to the current safety regulatory regime would continue uninterrupted.

That may still be the case, but unfortunately problems have arisen which threaten to greatly complicate the situation. In particular, the inflexibility shown by the Commission in the main Brexit negotiations has been repeated in the aviation sector, especially in relation to allowing preparation for post-Brexit arrangements to begin before the principal EU/UK negotiations have been completed. This is particularly important in case the outcome of the negotiations is No Deal.

There has been growing concern that failure to engage in informal exchanges now could lead to disastrous consequences, mainly because of the absence of legal certainty. As a result, two industry trade bodies — ADS, representing the UK aviation manufacturing sector, and GAMA, representing the majority of the world's manufacturers of general aviation aircraft and equipment — wrote in June to Michel Barnier, the EU Chief Negotiator for Brexit, urging a different approach as a matter of urgency.

The ADS/GAMA concern is shared by the UK Government and CAA, resulting in further pressure being applied behind the scenes. In their letter the two trade bodies focus in particular on the problems faced by manufacturers, but the issues which they raise apply also to most of EASA's activities.

The letter notes: "*As we are now less than one year* [the letter was sent in June] *from the UK's exit from the EU, the concerns of our sectors are growing more pressing. The ongoing uncertainty on aviation safety arrangements means that companies face being forced to make investment decisions in the coming weeks and months based on the {worst?} case scenario. This does not benefit the UK or the EU27, and the impact as these irreversible decisions are taken will be felt in supply chains and operations across the whole of Europe and beyond…*

"The European aviation industry as a whole cannot afford any unintended consequences that arise from legal uncertainties. Any ambiguity in the legal status of UK certified designs and parts could result in aircraft being unable to fly anywhere. Similarly, uncertainty about the status of aircraft maintenance approvals, pilot and maintenance training approvals as well as pilot and technician licences threaten the continued operation of aircraft across Europe."

The strength of the words used reflect how serious this issue is for the manufacturing industry. ADS and GAMA point out that the transfer of responsibility to EASA from national authorities in 2003 created several serious, often unexpected, problems which even led to the grounding of some aircraft at the time. Unsaid, but clearly implied, was the message that it would be madness not to learn from this experience and walk blindly into another debacle, especially when there are obvious ways of avoiding such an outcome.

In conclusion, ADS and GAMA state that "*our risk analysis concludes that … EASA and the UK's … CAA need to urgently begin technical and contingency planning discussions by the June European Council, and separate to the political negotiations*." Michel Barnier's Deputy, Sabine Weyand, replied on 26 July, stating that "while I understand your request for technical discussions in order to limit disruption and safety risks, without sufficient clarity on both the outcome of the withdrawal process and the future UK legal framework, such discussions would currently be premature."

ADS wrote again to the Commission on 7 September, clearly frustrated at the lack of movement, saying: "*ADS knows that the UK Government has requested on several occasions that technical discussions between EASA and the CAA begin. We understand these have not been allowed to take place so far at the instruction of the European Commission. This is inconsistent with the letter and the spirit of the Commission and the Council calling on stakeholders to prepare for the consequences of Brexit."*

"… ADS understands that detailed bilateral discussions at a technical level have already taken place between the CAA and the US, Canada and Brazil. As long as the Commission blocks similar bilateral technical discussions between the CAA and EASA, it fosters uncertainty and risks legal liability, insurance and passenger safety issues for the global aviation and aerospace industry."

ADS and GAMA are trade bodies lobbying on behalf of their members, but the arguments they have presented really cannot be viewed as an exaggeration of the situation. There is clear and growing frustration at what many see as the Commission's unnecessary inflexibility. It cannot be said too often: time is running out. If the Commission's objective is to increase the pressure on the UK in the broader political negotiations, it may have miscalculated, with potentially very serious consequences. Everything may, of course, work out satisfactorily in the end, and that is certainly most people's hope, perhaps even expectation, but the risks are substantial and increasing.

Market access

When it comes to panic, however, most public attention has been directed at market access. The creation of the EU internal aviation market, ironically to a large extent a UK initiative, has been a huge success and radically changed the airline industry in Europe. Add to this the fact that the UK is the largest source of intra-European air traffic, not least tourists, and that the problems created by Brexit affect continental European (and Irish) stakeholders almost as much as UK ones, and it is not unreasonable to ask why anyone other than the most hardened European bureaucrat determined to punish the UK for its Brexit decision would choose to damage such an EU policy success.

In the absence of formal contacts between the EU and UK on airline market access, it is obviously difficult to be certain on what the eventual outcome might be. (The UK Secretary of State for Transport met the EU Transport Commissioner recently, with aviation one of the topics on the agenda, but few details have emerged on what they discussed. In any case, more detailed exchanges between officials are what is really needed.)

However, it is possible to make an educated guess by asking what type of bilateral arrangement might the EU seek with the UK if the latter had never joined the Union. What would the EU be saying if the UK was a long-standing, fully independent State?

A clue to the answer to this question was provided in a speech given in July by Henrik Hololei, Director General for Mobility and Transport at the Commission. Speaking to the International Aviation Club in Washington DC, Mr Hololei stuck rigidly to the Commission line on Brexit, noting: "*What is clear is that the UK would not be able to benefit from the similar access to the EU aviation market as now and the UK carriers will not be considered European carriers anymore. The UK would also cease to be a full member of the European Aviation Safety Agency once it exits the EU.*"

This is all very well, but doesn't go much beyond stating the obvious. However, Mr Hololei actually spent most of his speech addressing the broader EU external aviation policy, and in particular the EU/US agreement which last year celebrated its tenth anniversary, and here he was much more revealing about what might follow Brexit. The EU/US "*historic game changer*", as he put it, has been a success, despite the fact that the partners' share of global traffic has fallen from some 50% to 37% since its inception. Most importantly, he argued, much more could have been achieved, and could still be achieved if there was more commitment to reform.

Where the EU/US Transatlantic Aviation Area (TAA) fell short of European hopes and expectations was in its failure to address the national ownership and control rules which still widely apply to airlines. Despite efforts by the EU, following similar attempts by the UK over many years, the US refused to adopt a new approach to these long-standing restrictions (nor would it allow foreign airlines to operate cabotage services in the US), going no further than to agree to continue discussions. Over the ten years since the TAA came into existence, there has been no progress at all in this area.

Mr Hololei was clear about the need for reform: "*If we look at this today then I believe that, in order to enhance competition and advance investments to the European carriers, we need to re-think the Ownership and Control regulation more generally. It is very difficult to understand why we have these restrictions that are not present in any other industry.... I believe in the potential of truly global carriers and, if I look at the possible challenges to the sector, then that might also be very important for the future of the industry.*"

Then comes the critical statement: "*...let me remind you of my vision for the EU-US aviation relations that I have shared with you over the past years: a creation of a genuine Transatlantic Aviation Area that combines both markets ensuring high standards, leading to high connectivity and tremendous synergies. A yardstick for the global aviation community, a lasting influence for the future development of our sector! This was the dream of the negotiators of the ATA and the spirit of the negotiators of the Agreement, when we committed to remove market access barriers, further enhancing the access of our airlines to global capital markets, and to lead by example.*"

Clearly what Mr Hololei is saying is that the EU Commission is still committed to the original proposals for what was then termed the 'Open Aviation Area' and presented to the US at the beginning of the negotiations. This negotiating mandate had the support of all 28 EU Member States and the wider European aviation industry. Indeed, it was originally drafted by the Association of European Airlines, then the trade body of the legacy carriers in Europe.

Europe's objective, building on the success of the EU internal aviation market, was to create an enormous free trade bloc for air transport, accounting for some 50% of the global industry. Essentially this would involve taking the current EU internal aviation market and stretching it across the Atlantic.

All the old bilateral restrictions on market access (including cabotage), pricing and crucially ownership and control would be swept away. Unfortunately, while much of the proposal was acceptable to the US, not least because it coincided with its own long-standing Open Skies policy, the US would not accept reform of the airline ownership and control rules and cabotage services.

From one perspective, it is surprising that the Commission is maintaining this liberal approach in the face of mounting pressure in Europe for a more restrictive external aviation policy, best illustrated by the campaign by the likes of Lufthansa and Air France/KLM to curtail the expansion of the Gulf carriers. Many had expected the departure of the UK from the EU to weaken the Commission's hand and force it to become more protectionist, but there is no hint of such an about-turn in Mr Hololei's speech.

Rather he notes that one of the biggest challenges facing the industry and regulators today is "*protectionism driven by an agenda influenced by renewed nationalism and wide-spreading populism... Protectionism ... leaves a flawed picture of temporarily increased job security but after the first indirect effects this quickly evaporates. It is important that Eu-*

rope does not fall into this growing camp but continues to fight for global open markets that serve us best."

One might wonder what Lufthansa and Air France/KLM thought of such a clear and unambiguous restatement of the Commission's long-standing external aviation policy, not to mention any supporters of President Trump in the audience. However, it is certainly consistent with the policy pursued in negotiations with both the US and Canada, although perhaps less so with respect to the attempt to reach a wide-ranging agreement with Brazil, which reputedly collapsed when the Brazilians lost patience with the EU reluctance to grant extensive fifth freedom rights. (Brazil has recently announced new bilateral agreements with several individual European States.)

The key question answered?

But what about the Brexit negotiations, once they eventually get underway, as they must at some stage — even a 'Hard Brexit' falling back on WTO rules for most industries would still require separate aviation agreements. Reverting to our earlier question — what would the situation be if the UK had never been a member of the EU? — the answer from Mr Hololei's Washington speech would seem to indicate that the Commission would be more than willing to negotiate a very liberal air services agreement between the EU/27 and the UK, one that effectively replicated virtually all of the elements currently found in the EU's internal aviation market.

It is difficult to envisage any other approach that would be consistent with the EU's stated external aviation policy, as outlined in Mr Hololei's speech. After all, no-one can question the UK's adherence to any fair competition rules, unlike the allegations made against the Gulf States, since it is following, and has undertaken to continue to follow, EU principles. The competitive playing field, for both UK and EU/27 carriers, is about as even as it could ever be.

Thus, if the EU is prepared to offer very liberal air services agreements to the US and others, why would it not be prepared to do the same for the UK, especially since Brexit creates almost as many problems for EU/27 airlines and airports as it does for their UK counterparts, not to mention the implications for the EU tourism industries? The only reason not to do so would presumably be to 'punish' the UK in some way, but such an approach would be a strange and short-sighted way to launch a new long-term relationship with a major trading neighbour.

To summarise: in the absence of a complete breakdown in relations between the UK and EU, along the lines outlined by the French Minister, there is every reason to believe that eventually agreements will be reached which, to all intents and purposes, replicate all of the current aviation regulatory arrangements.

The main problem is not so much the policies which both sides are likely to pursue, but the short-term inflexibility of the Commission in refusing to allow informal technical discussions to take place in advance of a broader Brexit agreement. Potentially this is a serious matter, putting safety and continued air services at risk. So perhaps Mr O'Leary was right after all — we should be panicking, at least a bit.

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Super-connectors: Two good, two bad?

OUR VIEW of the Super-connector sector is: there are two very successful models — Emirates, with its mega-bub at Dubai operated with A380s and 777s, and THY's long-haul, mostly 737, operation based at Istanbul — with both airlines achieving consistent profitability, displaying financial transparency and, despite the closeness of their relationships with their respective governments, not receiving direct subsidies. Then there are two models — Etihad and Qatar Airways — which have been successful in copying Emirates operationally, but which have never achieved commercial viability, have been supported financially by their governments and have been very opaque about their accounts.

Consequently, there is a supply/demand imbalance in the Super-connector sector. The graph below summarises the outlook, relating historic seat capacity offered by the Super-connector group compared to a probable demand projection. Following the series of political and economic crises in the Middle and Near East, the Super-Connectors as a group are no longer growing traffic at anything any their pre-2014 rates of around 15% pa. They have reverted to a "normal growth" profile, roughly 4-5% pa, yet the fleet plans and official scheduled deliveries still imply a 10%-plus capacity growth rate for the Super-connector group.

Tentatively, there could now be a 24m seat gap between theoretical supply and demand, which will have to be resolved through aircraft deferrals, cancellations and adjustments to delivery schedules — or through airline rationalisation. (24m seats equates to 19m passengers, which is roughly the traffic Etihad carries at present.)

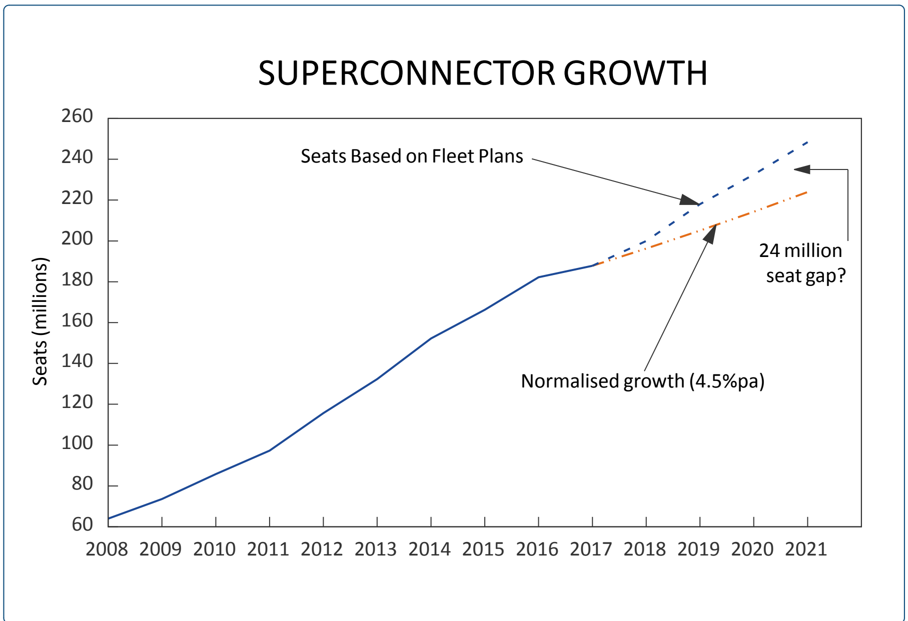
In late September it seemed that a long-speculated Super-connector merger was a possibility. Bloomberg, which normally has reliable sources, reported that preliminary talks were taking place with the aim of Emirates acquiring at least the main airline business of Etihad. Unfortunately, both airlines denied the report, although the two managements have been discussing issues like joint-security and the transfer of surplus Etihad pilots to Emirates.

Nevertheless, if there is to be any consolidation in the Super-connector sector Emirates-Etihad is by far the best bet. The graph below details the overlap between the seat capacity offered by the four carriers. For instance: only 5% of Emirates total seat capacity is on routes to destinations to which the other three do *not* operate.

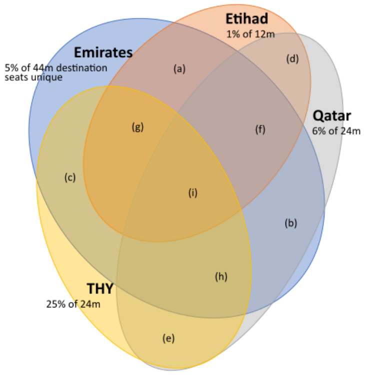
THY realistically is not in the running for any consolidation moves: the political and cultural differences are too large. Qatar — currently ostracised by its neighbours — is not in any position realistically to talk about joint ventures let alone mergers. However, the two UAE airlines overlap immensely, albeit that Emirates is over three times the size of Etihad: 73% of Emirates' seat capacity operated to the same destinations as Etihad's, and 93% of Etihad's capacity deployed to the same airports as served by Emirates.

Contrasting fortunes

Latest financial results underline the growing schism between the commercial and the statist Super-connectors.



SUPERCONNECTOR OVERLAP



Percentage of destination seats in direct competition

	Capacity intersection	Emirates	Etihad	Qatar	THY
a)	EK∩EY	73%	94%		
b)	EK∩QR	83%		78%	
c)	EK∩TK	76%			62%
d)	EK∩QR		93%	66%	
e)	QR∩TK			81%	65%
f)	EK∩EY∩QR	68%	89%	64%	
g)	EK∩EY∩TK	60%	77%		44%
h)	EK∩QR∩TK	66%		66%	53%
I)	EY∩QR∩TK		74%	57%	42%
j)	EK∩EY∩QR∩TK	56%	72%	56%	56%
k)	EY∩TK		79%		45%

James Hogan , CEO of Etihad from 2006 until his departure last year, was responsible for the multi-airline investment strategy, with its vague promise of mutual feed to boost the airline's catch-up growth strategy — in reality a series of hopeless airline investments- and is now apparently running a private equity fund in Switzerland. His legacy at Etihad, and it had been obvious for years, was strategic chaos. Hogan's successor, appointed in September 2017, is Tony Douglas, formerly of BAA, Abu Dhabi Ports and most recently the UK Ministry of Defence, who has begun a reorganisation and restructuring programme at the airline. It is too early to assess the impact of his reforms, but it is somewhat disconcerting that the headline in *The Times* when he quit the MoD was 'Defence chief Tony Douglas jumps ship and "leaves MoD in chaos"'.

Etihad has produced some operational and financial results for calendar 2017 with comparisons to a restated 2016. Both sets of numbers refer to "core" operations without defining what this means, but presumably it is an attempt to insulate the Abu Dhabi airline operation from transactions involving Air Berlin, Alitalia, Jet Airways, Darwin (Etihad Regional), etc. Passenger volume and load factor remained more or less static at 18.6m and 78.5% in 2017 but total revenue edged up to $6.1bn. Core airline loss was $1.52bn, a margin of -25%, though an improvement on 2016's $1.95m, -33%, loss. We have been unable to reconcile the 2016 core result with any previously published Etihad result.

Still, Etihad is a relatively open compared to Qatar Airways. Even passenger numbers have not been reported since June 2017 when Qatar was abruptly embargoed by its Arab neighbours including Saudi Arabia, UAE and Bahrain as punishment for the country's alleged support for the Muslim Brotherhood. We estimate that for the full year, taking into account the embargo effect, passenger volumes for 2017/18 would have been roughly the same as the previous year — 32m. Overall, Qatar has not had to retrench too much in capacity terms: it was forced to close 18 routes but over the past year has added a similar number of new destinations, many in Eastern Europe.

CEO Akbar Al Baker has warned of a "substantial loss" to be reported for 2017/18 as the result of what he describes as the "illegal embargo" of his country. The accounts were due to be published in September but have not been revealed yet, though the airline has made indications in press statements. It claims that revenue increased by 7%, largely due to a 34% growth in its cargo business and its loss might be $69m (which does not seem particularly bad given the extent of the embargo.)

The problem is Qatar's financials have to be treated with a degree of caution. For instance, the 2016/17 published results showed a profit "attributable to shareholders" of $528m on revenues of $10.3bn, but this included various exceptional items — including some $575m in profits on asset sales, mostly aircraft sale and leasebacks; in underlying terms the Group appears to have produced an operating loss of $490m. In any case, such details are not too important in a hydrocarbon economy which has the highest GDP per capita, US$125,000, in the world.

Meanwhile, Qatar has expanded its investment portfolio this year, acquiring 50% of AQA, the parent company of Meridiana, which was relaunched as Air Italy. Qatar is leasing five A330s to Air Italy, as part of a plan to grow the carrier to 50 units (737 Maxes and 787s). Already however, the US majors are complaining about unfair subsidies for Air Italy which has started transatlantic services from Milan to New York and Miami. Qatar has also bought 25% of the third Moscow airport, Vnukovo, and a minority stake in JetSuite, the US private business jet operator.

These investments appear a little out of character with Qatar's previous concentration on prime **one**world assets — Qatar Airways has built up

LATEST SUPER-CONNECTOR OPERATIONAL AND FINANCIAL RESULTS

	Period	Pax (m)	Change	Pax LF	Change	Rev. ($bn)	Change	Op Result ($m)	Change	Net Result ($m)	Change
Emirates Group	FY 2017/18	58.5	4.3%	77.5%	2.4pts	27.9	8.1%	1,420	44.4%	1,106	67.2%
THY	2017	68.6	9.3%	79.1%	4.7pts	10.9	9.5%	794	from -350m	223	from -77m
	2018 (1st half)	30.3	17.8%	80.4%	4.3pts	5.9	29.2%	270	from -69m	41	from -434m
Etihad ("Core")	2017	18.6	-0.5%	78.5%	(0.1pts)	6.10	3.3%	na	na	-1520	22.1%

a 20% stake in IAG while the Qatar Sovereign Wealth Fund owns 20% of Heathrow Airport. It also has 10% stakes in **one**world members Cathay Pacific and LATAM and had a proposed 10% investment in American rejected.

THY's unique long-haul narrowbody hub operation has proved resilient in the face of political turmoil within Turkey, the devaluation of the Lira and, lately, an acrimonious fallout between Presidents Recip Erdoğan and Donald Trump.

After plunging into losses in 2016, after the attempted coup when tourism to the country collapsed, the airline recovered strongly in 2017, turning a $350m operating loss into a profit of $794m, driven mostly by holding capacity growth at 2%, increasing average load factors by 4.7 percentage points system wide, and pushing up yields by 2.9% — so RASK was up 6.0% overall, while CASK was held at 2016 levels.

Results for the first half of 2018 show a resumption of capacity growth, partly due to THY bringing parked aircraft back into service, of 9.2%. But this was surpassed by a traffic resurgence of 15.2%, with the consequence that RASK still grew by 15% (with only a minor currency boost) as load factors again grew by over 4 points and yields increased by nearly 11%. CASK was up by 11%, mostly due to fuel, and overall THY turned $69m operating loss into a $270m profit.

Average load factor for 2018 is expected to be over 81%, and total traffic is projected to be 75m passengers, close to capacity at Atatürk Airport. Fortunately, Europe's new mega-hub is scheduled to start operating in November — İstanbul New Airport or İGA located at Arnavutköy, north of the city's European side, 45km away from Atatürk. Initial capacity with three runways will be 90m passengers a year, (compared to current throughput of 78m at London Heathrow and 65m at Frankfurt). Further development will take İGA to 120m passengers by 2022.

Having suffered a shock in 2016/17 when its profits slumped, Emirates reined in capacity expansion in 2017/18; total ATKs, passenger and cargo, grew by just 2%, partly the result of retiring 8 widebodies to accommodate the delivery of 17 new A380s and 777s. Although by far the largest A380 operator and the sole orderer of this type in recent years, Emirates fleet policy is evolving to a more conventional mix of widebodies and ultra-widebodies (*Aviation Strategy*, November 2017).

With passenger volume up 4% to 58.5m, average load factor moved back up to 77.5% from 75.1% in the previous year. Total revenue for the airline (excluding dnata) increased by 8.5% in 2017/18 to US$25.2bn, aided by an improvement in yield and a positive currency effect, while profit attributable to shareholders jumped by 124% to $762m.

However, this equated to a profit margin of just 3%, which is significantly below the 10% margins Emirates regularly used to achieve and which is still the shareholders" target. Again this underlines the logic behind a capacity rationalisation by the two UAE airlines. Plus the fact that Emirates' fuel bill has now risen to 28% of total costs may also enhance the attraction of Etihad, based in hydrocarbon-rich Abu Dhabi, to Emirates, which with declining oil reserves in Dubai is exposed to global fuel prices.

Merger thoughts

Slightly unusually for an airline merger the most important issue in a Emirates-Etihad amalgam would be regal. The closely related ruling families of Dubai and Abu Dhabi — Al Maktoum and Al Nahyan — are intimately associated with their airlines, and aviation is more of a prestige industry than, say, aluminium, where two rival companies were successfully merged to form Emirates Global Aluminium in 2013. One of the strengths (or potential weaknesses) of the Dubai aviation sector is that one person, Sheik Ahmed Al Maktoum, ultimately controls Emirates Airline, flydubai,

SUPERCONNECTOR MEDIUM TERM SCHEDULED DELIVERIES

		2018/19	2020	2021	2022	2023	2024
Emirates	777	12	12	17	12	14	18
	A380	15	10	9	6	1	
	Total	27	22	26	18	15	18
Etihad	777		2	3	5	4	3
	787	15	8	17	6	6	
	A321	2		5	6	4	9
	A350	4	10	4	13	7	9
	Total	21	20	29	30	21	21
Qatar	777	8	7	7	11	11	10
	787	8	11	11			
	A320/21	6	11	12	11	10	
	A350	16	12	6	5		
	A380	1					
	Total	39	41	36	27	21	10
THY	737Max	24	24	15	12		
	A321neo	25	25	25	14	3	
	Total	49	49	40	26	3	
Super-Connector Group	777	20	21	27	28	29	31
	787	23	19	28	6	6	
	A350	20	22	10	18	7	9
	A380	16	10	9	6	1	
	A320 family	33	36	42	31	17	9
	737	24	24	15	12		
TOTAL		**136**	**132**	**131**	**101**	**60**	**49**

Notes: 2018/19 contains some units already delivered; Firm orders only

dnata, the CAA, Dubai Airports etc. Could Etihad and Abu Dhabi Airports be smoothly added to this portfolio?

In theory, Emirates plus Etihad would create the world's largest airline by RPKs, but the real issue is rationalisation. For the merger to make commercial sense, capacity has to be taken out of the super-connector systems; specifically Etihad's extensive orderbook will have to be re-negotiated (the new management there have apparently already started talks). Etihad is scheduled to receive an average of 24 units a year in the medium term, a mixture of 777s, 787s, A321s and A350s (see table above). Emirates is due to receive 21 units a year, one third A380s, the rest 777s over the medium term (before delivery of its latest A380 order kicks in).

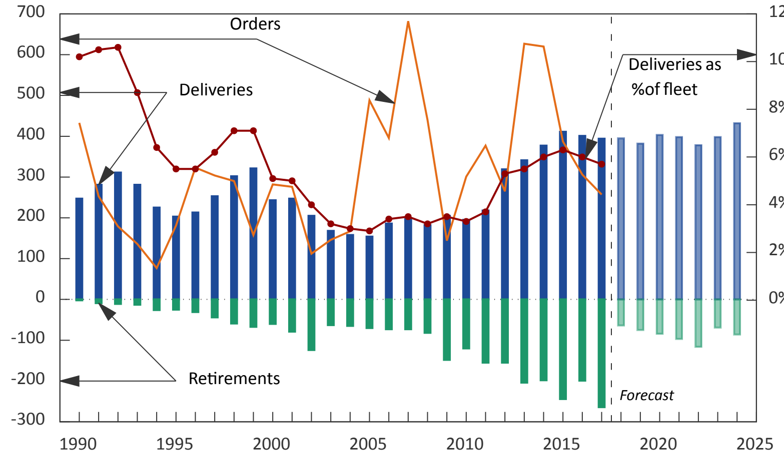
There is also the airport question — rationalisation of the hubs would also be required. DXB handled 88m passengers in 2017, close to its limit, estimated at 90m, and Emirates is due to start transferring operations to the all-new Al Maktoum International (Dubai World Central). The Dubai Government forecasts both airports to have capacity for 150m passengers by 2025 by which time Emirates should have transferred all its operations. The ultimate aim is for DWC to handle 240m passengers a year, but the precise date for that throughput is not being specified. Meanwhile, Abu Dhabi is also close to capacity with 25m passenger throughput and the government invested in facilities which will soon bring that up to 45m.

Consolidating at the DWC mega-hub would be rational, but regional sensibilities will probably not permit that. The solution then is a dual hub system *à la* Air France and KLM at Paris and Amsterdam. And the commercial risk is that Emirates-Etihad would end up like Air France-KLM in terms of management and branding, which is the easier merger option but not one that delivers full benefits of rationalisation, albeit through the brutal suppression of the weaker brand, United/Continental or America/USAirways for instance.

❀

Widebody world: growth / replacement trends

WIDEBODY AIRCRAFT ORDERS AND DELIVERIES



Source: Airline Monitor

IN THE past ten years since the global financial crisis the airline industry has been performing strongly. Total traffic demand since 2008 has grown at an average annual rate of 6% in RPK terms (and slightly less in the numbers of passengers), capacity by just over 5% and passenger load factors have risen from 76% to 82%. In the past five years, there has been an acceleration in growth rates: since 2013 demand has averaged an annual growth rate of 7%.

All this appears a little above the long term trend (depending on how you work it out) of 4.5%-5% pa growth.

Intriguingly over this period, from analysis of the schedules, long haul operations (which account for a third of total ASKs but just 8% of seats) and widebody operations have grown at a slightly lower rate.

Since 2011 we have seen a strong pick up in the numbers of wide body aircraft delivered into service.

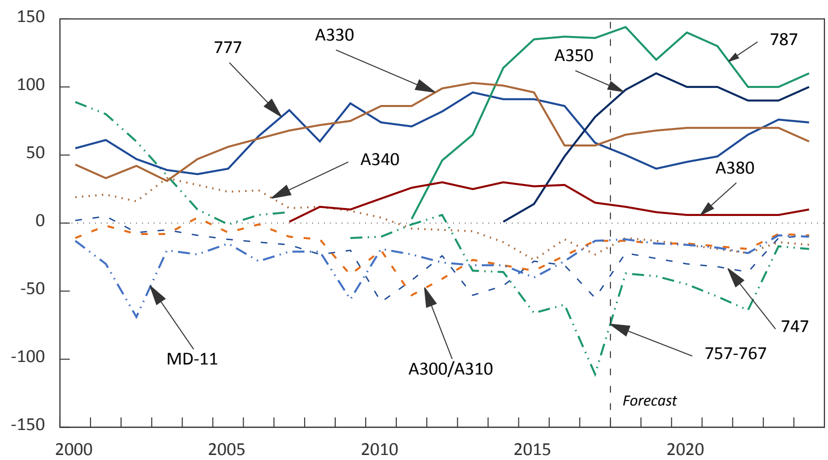
Deliveries and Orders

Through much of the noughties wide body deliveries averaged 150-180 a year (see chart above) equating to around 3% of the fleet in service. After taking account of the retirement of older equipment, this ratio falls to under 2%.

Since 2011 deliveries have doubled to around 400 units a year — although the numbers of aircraft leaving the global fleet have also risen strongly so net replacements still only accounts for 3%. This suggests that less than a third of new deliveries have been for growth. (This compares with a net replacement proportion of 5% for the narrowbody fleet over the same period.)

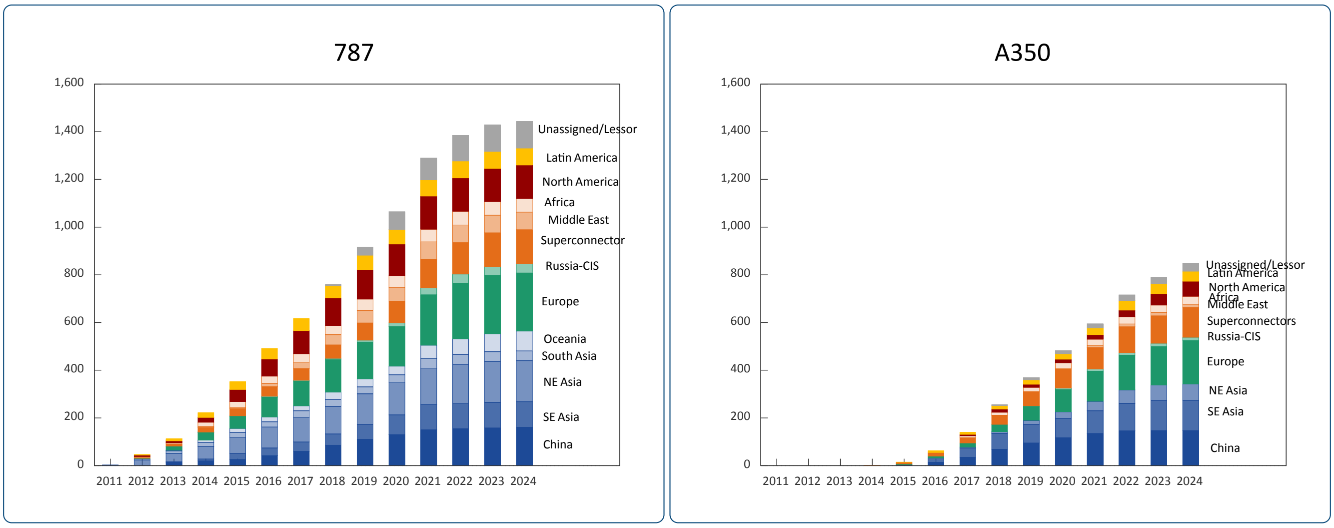
The aircraft order cycle is volatile but seems to respond to the financial health of the industry: airlines order equipment when they are optimistic and confident. Annual net orders for widebodies peaked in 2007 at 682 units — mainly for 777s, 330s, 787s (which entered service in 2011) and A350s (2015). This represented 27% of the total jet orders of 2,479 in

WIDEBODIES: NET ADDITIONS BY TYPE



Source: Airline Monitor

NEW GENERATION WIDEBODIES: FLEETS BY REGION



that year.

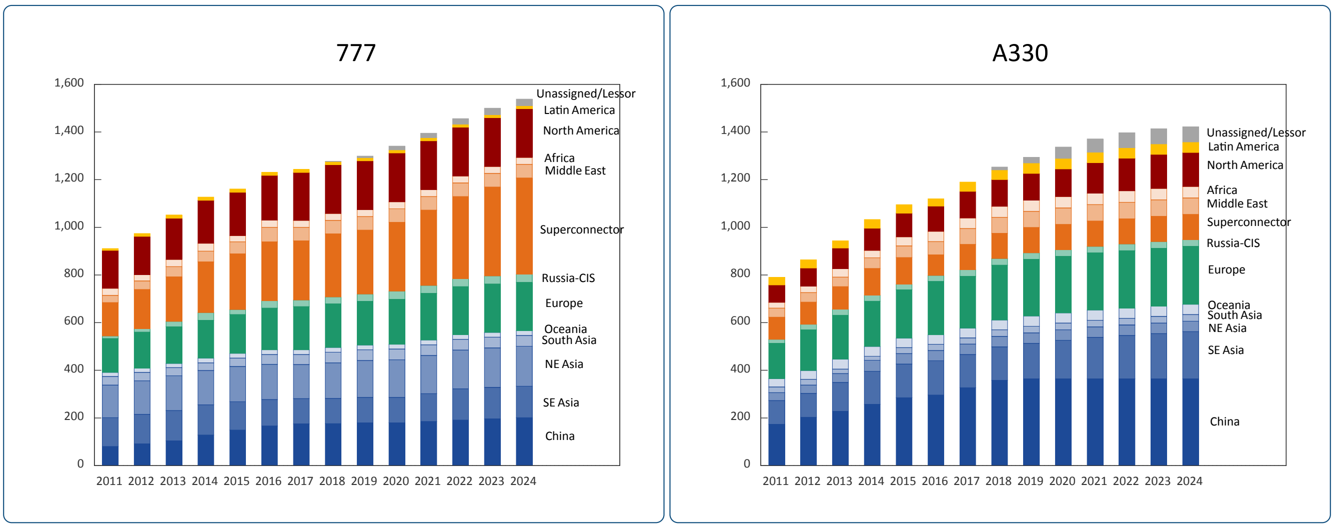
The latest order peak was in 2014, with 627 widebody orders reflecting only 17% of the total 3,649.

The total widebody jet fleet has grown from 3,304 units in 2011 to 4,244 at the end of December 2017, and the total number of seats these have available for operation by a compound average annual 5%. Unlike the narrowbody market the real number of operators round the world is quite small: 40 airlines account for 80% of the total fleet, while there is a long tail in the distribution of operators which operate only one or two widebody aircraft.

In that period more than half of the increase has been accounted for by acquisitions by the Superconnectors (Emirates, Qatar, Etihad and THY) and Chinese carriers for pure growth (see chart on page 13): elsewhere the priority seems to have been replacing aging equipment.

In 2011 the Superconnectors accounted for 9% of the total fleet but

OLDER GENERATION WIDEBODIES: FLEETS BY REGION



Notes: Passenger aircraft. Extrapolation of operating fleet by region based on dated orders and options by airlines based in respective regions.

787 ORDERS AND OPTIONS

	2018-2024			
	Orders	Options	Total	% of order book
Etihad	52	*12*	64	8%
SIA	53	*6*	59	7%
Qantas	6	*44*	50	6%
Air France-KLM	22	*25*	47	6%
JAL	13	*20*	33	4%
EVA	24	*6*	30	4%
Qatar	30		30	4%
Air Europa	16	*8*	24	3%
IAG	17	*6*	23	3%
Norwegian	13	*10*	23	3%
Aeroflot	22		22	3%
ANA	20		20	2%
China Southern	20		20	2%
United	18		18	2%
Gulf Air	16		16	2%
Korean	5	*10*	15	2%
Iraqi	10		10	1%
Jet	10		10	1%
Juneyao	5	*5*	10	1%
Shanghai	10		10	1%
Unannounced/Others	182	*27*	209	25%
Lessors	83	*2*	85	10%
Total	**647**	***181***	**828**	**100%**

Notes: this and following tables as at 31 Dec 2017, passenger aircraft.

A350 ORDERS AND OPTIONS

	2018-2024			
	Orders	Options	Total	% of order book
SIA	47	*16*	63	9%
Qatar	55		55	8%
IAG	43	*8*	51	7%
Etihad	47		47	7%
Air France-KLM	28	*15*	43	6%
United	13	*25*	38	5%
Lufthansa	19	*18*	37	5%
Asiana	26	*7*	33	5%
JAL	31		31	4%
Cathay Pacific	26	*4*	30	4%
China Eastern	20		20	3%
China Southern	20		20	3%
LATAM	20		20	3%
Delta	19		19	3%
Ethiopian	18		18	3%
Hong Kong Airlines	16		16	2%
Kuwait	10	*5*	15	2%
Aeroflot	14		14	2%
SAS	8	*6*	14	2%
Philippine Airlines	6	*6*	12	2%
Unannounced/Others	75	6	81	11%
Lessors	28	4	32	5%
Total	**589**	**120**	**709**	**100%**

had grown this to 13% by the end of 2017. In the period the total number of seats these aircraft represent had increased by a compound annual average of 13%. They (particularly Emirates) dominated deliveries of the A380 (accounting for 65% of the global deliveries of the type in the period) and favoured the 777 (28% of the total).

The carriers of greater China accounted for 10% of the fleet in 2011 and have increased the proportion to 15% by end 2017. The total number of seats has grown by 9.5% a year and ASKs by an annual average 9.2%. The carriers in the region have tended to go for 777s (17% of units delivered of the type) and A330s (31%). Intriguingly, as we pointed out in the May edition of *Aviation Strategy*, Chinese carriers have a need for high density equipment on relatively short haul routes, and 75% of the flights operated using A330s in their networks are on routes of less than 3,000km.

Carriers in most of the other regions acquired widebodies for replacement. One exception was in Europe where Norwegian, as pioneer

777 ORDERS AND OPTIONS

	2018-2024			
	Orders	Options	Total	% of order book
Emirates	85		85	29%
Qatar	54		54	18%
SIA	20	*6*	26	9%
Cathay Pacific	21		21	7%
LHAG	22		22	7%
ANA	19		19	6%
Etihad	17		17	6%
Aeroflot	6		6	2%
Korean	6		6	2%
China Airlines		*4*	4	1%
United	4		4	1%
Air India	3		3	1%
Air China	1		1	0%
Unannounced	27		27	9%
Total	**285**	***10***	**295**	**100%**

A330 ORDERS AND OPTIONS

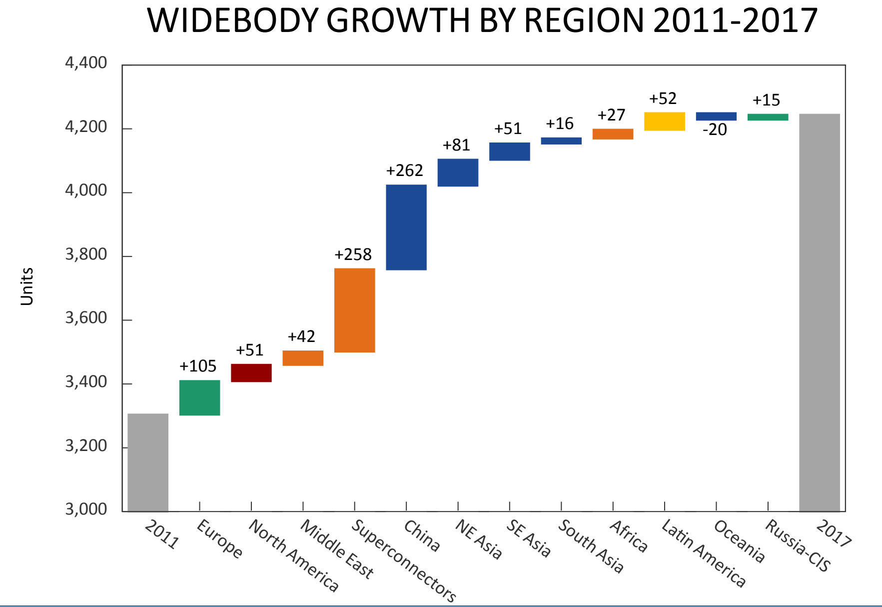
	2018-2024			
	Orders	Options	Total	% of order book
AirAsia X	45		45	19%
Delta	25		25	11%
TAP	18		18	8%
Garuda	14		14	6%
Hong Kong Airlines	10		10	4%
China Eastern	9		9	4%
Hawaiian		*6*	6	3%
Azul	5		5	2%
Hainan	5		5	2%
IAG	4	*1*	5	2%
WOW air	4		4	2%
Others	23		23	10%
Unannounced	9		9	4%
Lessors	55		55	24%
Total	**226**	***7***	**233**	**100%**

of the long haul low cost operating model, accounted for 12% of the net increase in the widebody fleet as it took delivery of the first 12 of its 787s.

Future deliveries

While the ordering spree of the last five years may not have show as much exuberance from the world's airlines for widebody as narrow, there were still some 2,200 orders — slightly favouring the lower seat capacity new generation 787s and A350s, but nevertheless also featuring the remodelled 777X (due to enter service in 2020) and to a lesser extent the A330neo (2018). The widebody order backlog stood at 2,320 aircraft at the end of 2017. If anything it looks as if the industry is currently favouring slighly smaller aircraft in seat capacity but with range.

Some of these orders are fairly long-dated, but the widebody orderbook is by no means as constrained as the narrowbody. Over the next six years the two manufacturers look set to continue to deliver around 400 units a year.



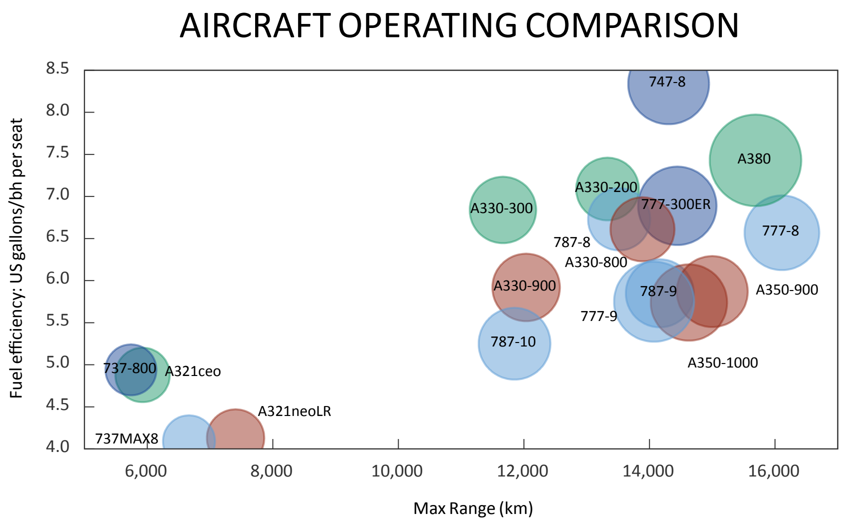
In the charts on page 11 we show an extrapolation of the regional developments of the main current aircraft types for 2018 to 2024. These are all based on the dated orders and options where identifiable to operators. It is noticeable that the Chinese carriers in general — one of the main engines of growth since 2011 — have few identifiable orders or options. A major reason for this may be politics: real orders for these carriers are likely to be included in the segment "unallocated/lessors".

In the tables on the facing page we show these same orders and options by carrier. Not all of these order positions should be regarded necessarily as truly *firm*.

Note that Etihad is supposedly reponsible for 64 (8%) of the 787 orders and options up to 2024, 17 (6%) of the 777s and 47 (7%) of the A350s. Emirates and Qatar, meanwhile, have 85 and 65 777s on order for delivery over the seven year period, respectively accounting for 29% and 18% of the type's passenger deliveries by 2024.

Note also that long haul low cost operator AirAsia X heads the list for the A330neo with orders for 45 by 2024.

At the end of 2017 it had orders in place for a total of 66 A330-900s, and then at this year's Farnborough air show supplemented its position with an order for a further 34 giving it nearly 40% of Airbus's backlog of the type.



Source: Airline Monitor. Notes: Area of bubble directly related to number of seats ("Standard" three class configuration). Consumption figures estimated for A330-800/900, A350-900/1000, 787-10, 777-8/9.

WestJet: LCC to "high-value global network airline"

CANADA'S WestJet is in the midst of an ambitious transformation from an upmarket LCC into a full-service airline that caters for every kind of travel need. This involves scaling up the new ULCC unit Swoop, launching 787 operations in January, building a long-haul network to Asia and Europe, developing a dedicated premium cabin product, and capturing a greater share of premium travellers. WestJet also needs to secure a contract with its unionised pilots and keep unit costs in check.

The strategic shift, unveiled in February 2017, seemed risky from the start, but WestJet's track record of profitability and executing multiple strategic projects since 2010 won over the initial critics.

But this year has seen alarming developments. WestJet's pilots threatened industrial action in the spring, which came close to preventing Swoop's launch, damaged the WestJet brand and led the airline to report its first quarterly losses in 13 years for Q2.

WestJet was fortunate to avert the strike threat in late May when it agreed with ALPA on the settlement process, which includes binding arbitration, if necessary. But the contract could lead to significant labour cost inflation.

WestJet attributed its Q2 losses to a 31% surge in fuel prices, as well as domestic yield pressures resulting from overcapacity. The airline is especially concerned about the "doubling of the network of a ULCC competitor" this past summer (Flair Airlines, more on that below).

One more thing to add to WestJet's challenges: several management changes in the past several months, including a new CEO. Former CEO Gregg Saretsky resigned in March amid the labour strife, and new CEO Ed Sims only joined the company last year.

It all adds up to a challenging financial outlook. In early August JP Morgan projected that WestJet's EBIT margins would dip to historical lows of 3.3% and 5.5% in 2018 and 2019, respectively.

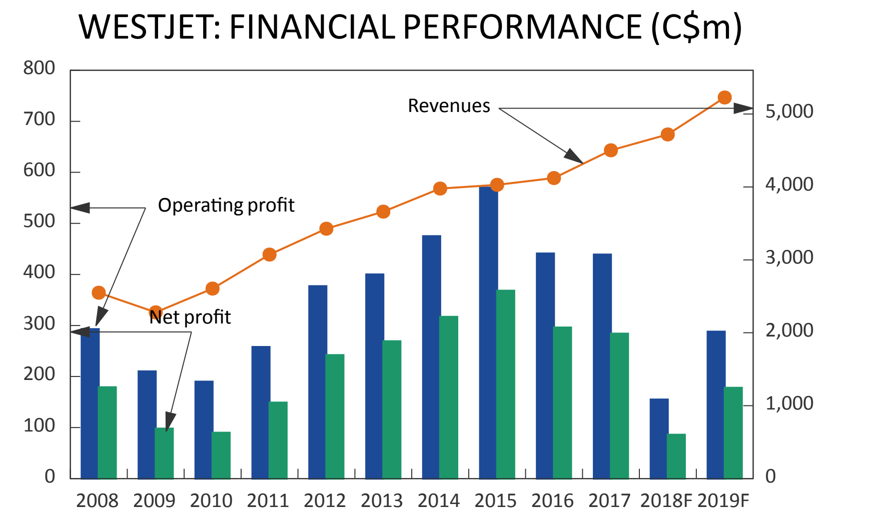
JP Morgan noted WestJet's "troubling" cost trajectory. While 2019 unit costs cannot yet be accurately projected because there are so many moving parts, in the best estimate WestJet's 2019 ex-fuel CASM (10.34C¢) will be only 4% below Air Canada's 10.80C¢ — quite shocking as WestJet is still an LCC and Air Canada is a full service airline. Four years ago WestJet had a nearly 20% cost advantage over Air Canada (on a non-stage length adjusted basis).

This adds to the pressure to grow Swoop rapidly and obtain ULCC-level CASM for the unit. Yet WestJet's management is also under pressure to stem the 2018-2019 margin degradation.

WestJet has announced a six-point reduction in its planned Q4 growth rate, which results in 2018 ASM growth declining from 6.5-8.5% to 5.5-6.5%. The management is also "re-evaluating the phasing and implementation" of some of the strategic projects, which could be announced at the investor day in December.

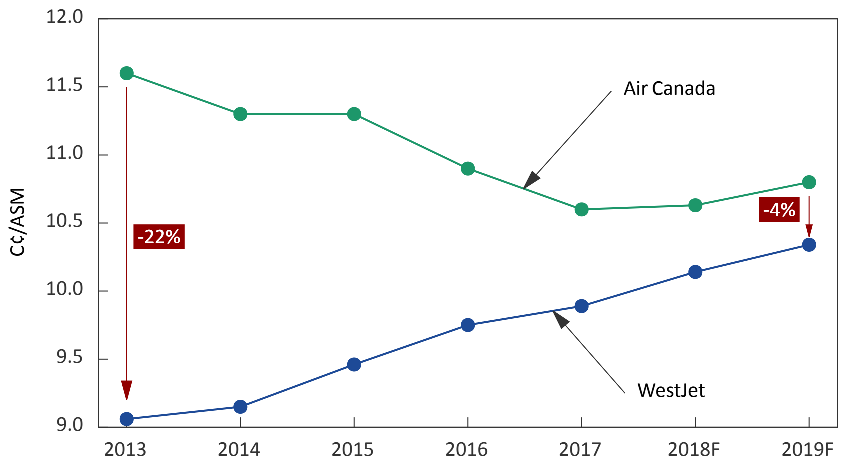
Why the strategic shift?

The main reason why WestJet is diversifying away from its tried-and-tested, profitable LCC model is that it



Note: 2018 and 2019 forecasts by J.P. Morgan (August 2, 2018)
Source: Company reports

WESTJET'S DIMINISHING COST ADVANTAGE



Notes: Data not adjusted for average stage length differences. 2018F = Mid-point of each airline's guidance; 2019F = Forecasts by J.P. Morgan.
Source: Company reports

needs new growth areas. It has 37% of domestic ASMs (a virtual duopoly with Air Canada in the domestic market), 21% of ASMs in the Canada-US market and a strong position in the Canadian winter sun market to Florida/Mexico/the Caribbean.

But with Canada's 36m population (2016), WestJet does not have the opportunities that US LCCs enjoy in being able to tap the huge US market for domestic and near-international expansion.

WestJet knew already in 2011 that it would benefit from diversification, both geographically and with its business model. It has moved aggressively to capture business traffic in Canada, launched regional subsidiary WestJet Encore (2013), entered the transatlantic market (with 737s in 2014 and 767-300ERs in 2016) and tested the Canada-Hawaii market.

At the same time, Air Canada too has increasingly diversified into WestJet's territory; most notably, it has set up its own low-cost unit Rouge.

There is a strong defensive element to WestJet's latest diversification moves. The competitive landscape in Canada is changing, with both existing operators and new entrants increasingly posing a potential threat to WestJet's market position.

Air Canada is growing faster domestically. Rouge has had its earlier 50-aircraft cap removed. LCC Air Transat is planning European expansion, while Sunwing is stepping up growth on the winter sun routes.

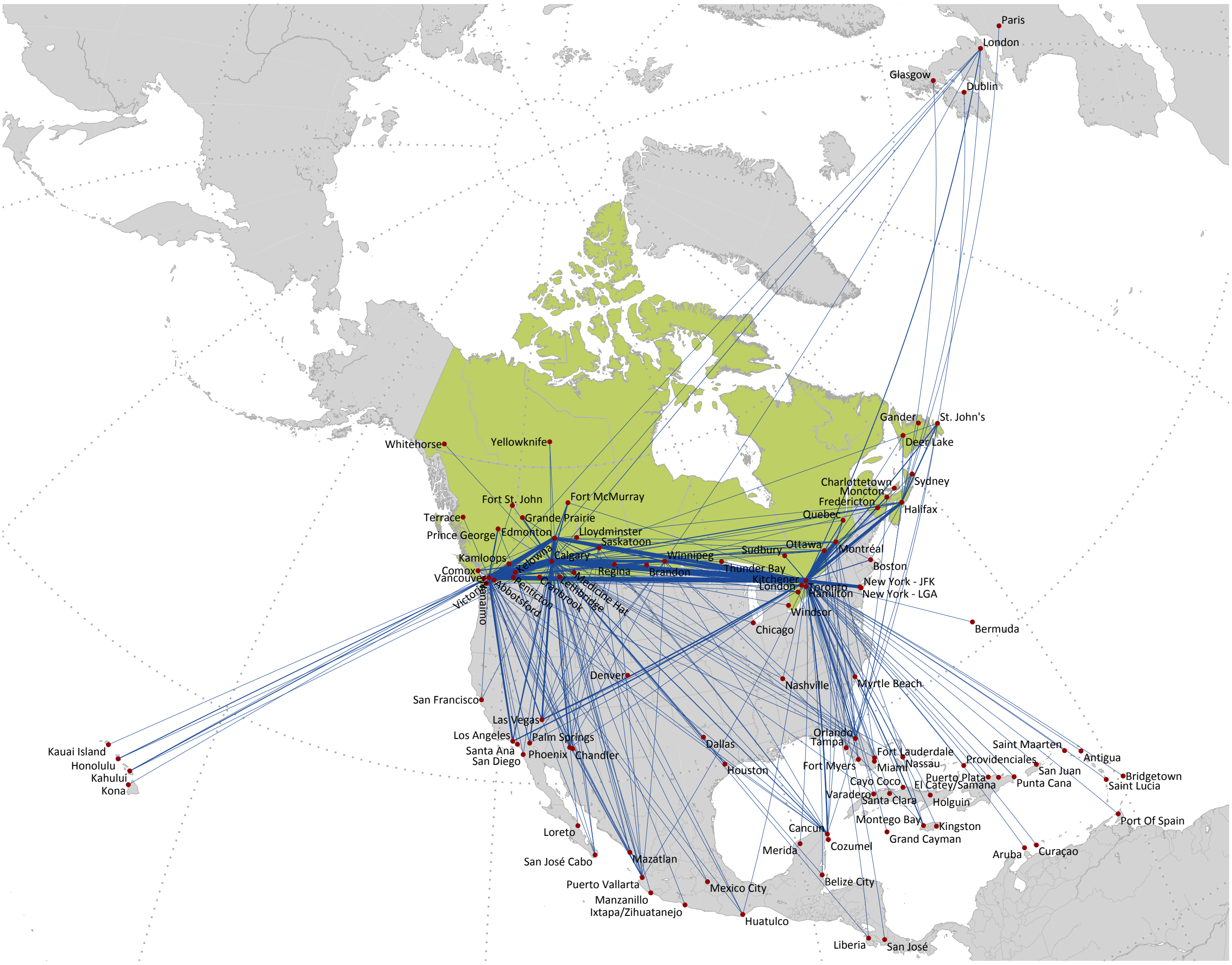
But upstart ULCCs pose the biggest threat to WestJet's domestic market share. Despite being a tough market for new airline entrants, Canada has suddenly become a hotbed of ULCC start-up activity. WestJet's biggest priority this year was to get Swoop launched and

WESTJET: FLEET PLAN

	Current	Future deliveries							Fleet
	Fleet†	**2018**	**2019**	**2020**	**2021**	**2022-23**	**2024-27**	**Total**	**2027**
737-600	13								**13**
737-700	54								**54**
737-800	48								**48**
737MAX 7					1	2	19	22	**22**
737MAX 8	7	4	6		2	2		14	**21**
737MAX 9						10	2	12	**12**
767-300ERW	4								**4**
787-9			3	3	4			10	**10**
Q400	47								**47**
Maximum‡ fleet	173	4	9	3	7	14	21	58	**231**
Lease expiries			-6	-5	-11	-12	-7	-41	**-41**
Minimum§ fleet	173	4	3	-2	-4	2	14	17	**190**

Notes: There are options to purchase another 21 MAX aircraft and ten 787s for 2020-2026 delivery. The MAX 7 and MAX 8 orders can be substituted for one another or, beginning in 2022, for the MAX 10. † At 30 June. ‡ all leases renewed § all leases allowed to expire
Source: WestJet

WESTJET ROUTE NETWORK



scaled up before new ULCC competitors could get a foothold.

WestJet has been lucky on that front. Two of the companies that originally looked the strongest — Canada Jetlines and Enerjet — have both experienced fundraising delays and are unlikely to start operations before 2019, at the earliest. That was despite the fact that in late 2016 the government exempted them from the earlier 25% foreign ownership cap (the Act that raised the cap to 49% finally became law in June 2018).

Instead, former charter operator Flair Airlines, which now markets itself as a ULCC, has become WestJet's biggest immediate concern. Flair began scheduled flights after absorbing ULCC hopeful New Leaf in June 2017, and this summer it doubled its domestic operations to cover 10 cities. The airline will make a big transborder push this winter, with service to six US destinations from December. It plans to start transitioning from 737-400s to 737-800s in early 2019.

Geographical diversification also helps protect WestJet from adverse economic and exchange rate developments. As a non-US airline, its dollar-denominated costs rise when the Canadian dollar weakens.

WestJet has been profitable through its 22-year history, except for a small operating loss in 2004. It has proven that it can be successful in the competitive transatlantic market where it does not have much of a cost advantage. It continues to enjoy a strong balance sheet, ample cash reserves and investment grade credit ratings. Cash represented 28% of LTM revenues in June. Adjusted debt-to-equity ratio was 1.42 and adjusted net debt-to-EBITDAR ratio was 2.18.

The management stated in August that it still intended to achieve the 2020 financial targets laid out in its December 2017 plan, which include achieving ROIC of 13-16%, operating margin of 10-12% and adjusted net debt-to EBITDAR of 1.2. But ROIC was last in that range in 2015 and fell to 7.7% in the 12 months ended June 30.

WestJet's results in 2018 are so seriously off-track that attaining the 2020 targets seems challenging — at least without a significant scaling down of the strategic initiatives. The problem there is that the key initiatives seem essential for achieving the cost and revenue targets. WestJet would be especially loath to reduce Swoop's growth rate now that there is an aggressive ULCC competitor in the market.

Perhaps WestJet will find a way to slow new aircraft deliveries without too much adverse impact on the strategic initiatives. Currently its capital plans show a peak in 2019 at around C$1bn, which includes C$820m aircraft capex.

Plans for ULCC Swoop

Swoop took to the air in June with two 737-800s, initially focusing on a five-point domestic network (Abbotsford, Edmonton, Halifax, Hamilton and Winnipeg). It has since received regulatory approvals to fly to the US, Mexico and some Caribbean countries and will be adding its first seven Canada-US routes in October — ahead of Flair's transborder entry. The initial US destinations are Las Vegas, Phoenix/Mesa, Orlando, Tampa Bay and Ft. Lauderdale.

In early September Swoop operated four 737-800s. The plan is to build the fleet to six units by December and 10 by the autumn of 2019. All of the aircraft come from WestJet and they have been converted to a 189-seat higher-density configuration.

The business model is typical ULCC: fully unbundled fares, high ancillary revenues, high utilisation, high labour efficiency, direct-only distribution and simplicity. Costs are targeted to be 30-40% lower than WestJet's.

Swoop's AOC, brand, employees, headquarters, airport operations and website are all separate from WestJet. The unit is led by a WestJet EVP.

The target market is price-sensitive travellers, as opposed to WestJet's "core leisure and premium guests". The idea is to stimulate travel (about 50% of the target market).

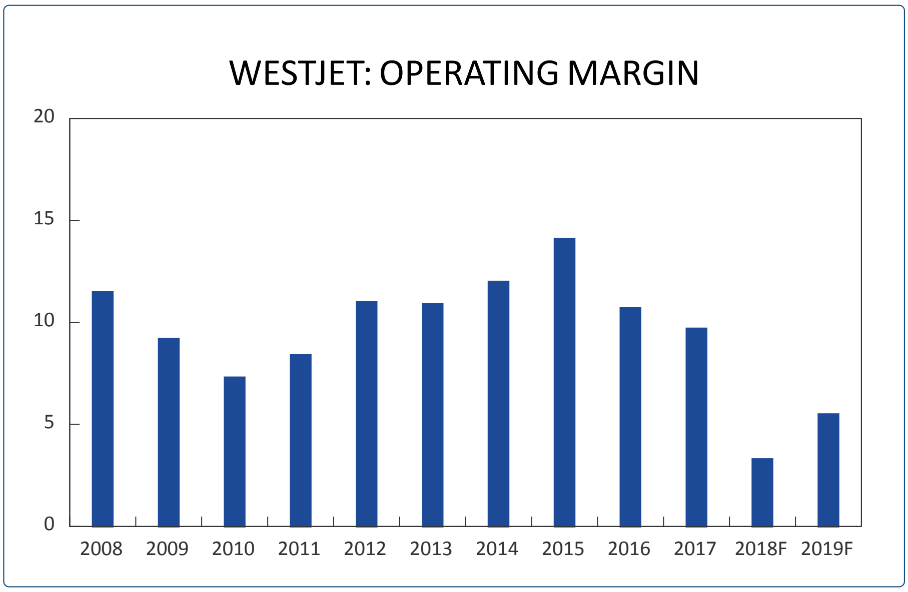
A further aim is to capture what WestJet calls "cross-border leakage" (25% of Swoop's target market). Some 5m Canadians annually cross the border to US airports such as Bellingham and Buffalo to catch cheap flights operated by US ULCCs such as Spirit and Allegiant. From Abbotsford and Hamilton on the Canadian side, Swoop can match the US ULCCs' fares to popular leisure destinations such as Las Vegas and Florida, especially since Abbotsford and Hamilton are lower-cost, "highly collaborative" airports.

The main tool for preventing Swoop from cannibalising yields at WestJet is to keep the two networks separate. Swoop operates point-to-point services and does not feed to WestJet's long-haul network.

WestJet originally outlined a 6C¢ ex-fuel CASM target for Swoop, which according to JP Morgan was about 0.8¢ higher than the stage-length-adjusted US ULCC average to account for structurally higher costs in Canada (especially airport and navigation fees). The 6¢ target will only be realised when Swoop gets economies of scale with a 10-strong fleet.

Apparently the proposed ALPA wage settlement is not that different from WestJet's original assumptions, so the 6¢ target still stands. However, the mere fact that Swoop's pilots are unionised (and all come from WestJet) could mean less operational flexibility and limit the unit's potential to drive down costs.

Only a few months ago ALPA was alleging that WestJet broke their contract by introducing Swoop. It could



take a while to repair labour relations.

Swoop's early results have surpassed expectations, though, with load factors consistently exceeding 95% and ancillary revenue per passenger approaching double that of the mainline operations. WestJet executives said recently that they are "actively looking" to accelerate Swoop's growth from the 6-10 aircraft committed so far.

But Swoop will always be a small airline. Canada is a small market. Earlier this year WestJet's former CEO said that he envisaged Swoop "one day" operating a fleet of 30-40 737-800s.

The up-market push

As a high-quality LCC with an award-winning product, a strong brand and a great domestic market position, WestJet has always attracted business and premium traffic. It has courted it with *Plus* premium economy seating with extra legroom (introduced in 2012), better schedules, improvements to the FFP and suchlike.

But, in the words of one analyst, WestJet still "punches below its weight with higher-value travellers in Canada". That is partly because of gaps in its product offering, such as not having a dedicated premium cabin product (like, for example, JetBlue's Mint), Also, *Plus* is not as attractive as competitors' comparable offerings.

The 787 and the 737 MAX have provided an opportunity to rectify that. The 787 fleet will feature WestJet's first-ever, albeit "appropriately sized" dedicated premium cabin, which among other things will include lie-flat seats.

If successfully executed, the 787 premium offering could potentially disrupt the segment as much as JetBlue's Mint did in the US. But it could also be an earnings headwind. Long-haul international is a tough market, full of global carriers with more spending power and experience in perfecting their premium cabins. Much will also depend on correct route selection and revenue management.

It is even more important for WestJet to capture more premium traffic in the domestic market. It will help offset Swoop's lower yields. WestJet hopes that an enhanced *Plus* offering on the MAX 8s, together with the upgrades planned to the 737-800's, will do the trick.

WestJet is targeting C$300m of incremental domestic premium traveller revenue — by far the biggest contributor to the overall revenue opportunity of up to C$500m it has identified through 2022.

In addition to global growth, the other revenue contributors include a new transborder JV with Delta, new fare and ancillary products and enhanced revenue management tools.

WestJet continues to cater for different customer segments with fare bundles (*Econo*, *Flex*, *Plus Lowest*, *Plus Flexible*). Oddly though, and as a sign of how complicated the business model is becoming, WestJet is also introducing Basic Economy fares across its domestic and transborder networks (that fare type is the US legacies' primary weapon against ULCCs).

Global expansion with the 787

WestJet has four-plus years of experience operating on the transatlantic. In 2014 it introduced seasonal Toronto-Newfoundland-Dublin services with 737s, adding a second route, Toronto-Halifax-Glasgow, the following year. In 2016 it began operating nonstop flights to London Gatwick from six Canadian cities with its owned 767-300ERs.

WestJet is now about to embark on a significant new phase of its international expansion as it receives its first 787s in early 2019. It has firm orders for 10, scheduled for delivery in 2019-2021, plus 10 options (available in 2020-2024).

But WestJet has currently no plans to start retiring the 767-300ERs, which it considers add useful cargo capacity and are ideally suited for flights of 6-8 hours' duration.

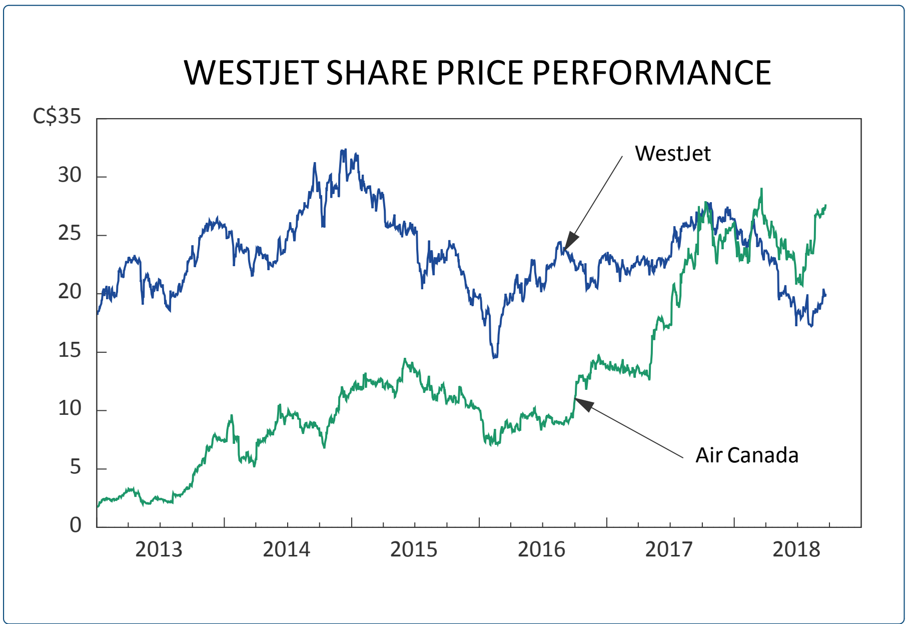
The airline unveiled the 787's livery, logo and cabin interiors in Q2. In line with the strategy to become a full service airline, the 787s will be operated in three-class configuration. Back in the summer, WestJet talked about launching sales in Q4 and having the first aircraft in service by the end of January.

As of September 18, WestJet had not yet announced any 787 destinations. The type's range from Calgary, Toronto and Vancouver will literally open up the world, but more destinations in Europe, some Asian routes (especially China) and possibly upgauging the key London routes to the 787 are thought to be early priorities.

WestJet will benefit from Canada's great collection of traffic rights around the world, which Air Canada too only began seriously taking advantage of fairly recently.

But WestJet can expect more and bigger competitive clashes. Asia happens to be a key growth market for Air Canada. It was indicative that Air Canada and Air China recently announced plans for an enhanced JV.

WestJet is in a much stronger position than the typical point-to-point LCC in that its extensive domestic and North American networks can provide significant feed to long-haul international services.



To supplement the feed provided by its own 737 operations and by wholly-owned regional unit Encore's 45-strong Q400 fleet, in June WestJet launched its first contracted flying under a capacity purchase agreement (CPA). The initial "WestJet Link" contract, with Pacific Coast Airlines in Calgary, is very modest, but the model can be replicated across Canada. PCA's 34-seat Saab 340Bs are painted in WestJet colours and have six Plus seats available.

Airline partnerships will play a major role in making the global strategy successful. WestJet is an old hand at those and has codeshares in place with numerous airlines. Two things mentioned in recent months are talks with Air France-KLM to deepen transatlantic cooperation and exploring new or deeper relationships on the transpacific.

One particularly significant development is the signing of a Delta/WestJet transborder JV in July. The deal covers 30-plus cities or nearly all of the US-Canada demand. It envisages expanded codesharing, FFP and reciprocal elite benefits, joint growth across the transborder network, co-location at key hubs and cooperation in cargo and corporate contracts. The airlines expect to obtain the regulatory approvals in the first half of 2019.

This deal is important because it could materially help WestJet secure feed from the US to its future 787 services and aid its quest to become a full-service, global airline. It could be the first and only immunised JV in the US-Canada market, though it has to be only a matter of time before Air Canada and United revive their earlier JV plans.

Uncertain cost outlook

In May, to avert industrial action and get the pilot contract settlement process agreed, WestJet made a major concession to ALPA: it agreed that Swoop pilots will be unionised and covered by the same contract as the mainline pilots.

In other words, Swoop pilots will have the same pay rates as WestJet pilots, who are now seeking wage parity with Air Canada pilots. However, it looks like pilots transferring from WestJet to Swoop will lose their seniority, enabling Swoop to obtain some savings through a young workforce. It is not yet known if there will be productivity concessions to facilitate more flexible work rules at the ULCC.

With the negotiations continuing, it is unclear how swiftly and amicably the first ALPA contract can be put in place and how much it will inflate WestJet's labour costs. Pressures on that front will continue also because in July WestJet's and Swoop's cabin crew members voted to join a union.

Nevertheless, WestJet is committed to "staying ahead of our cost inflation" and even widening its competitive cost advantage with Air Canada. The management calls 2018 a "year of transition" that has included significant start-up expenses and expensive product launches. Thanks to the 737 densification and other projects, WestJet is on schedule to meet its "cost transformation program" goal of C$200m annual savings by the end of 2020.

The transition to the 737 MAXs over time and the growth of the 787 fleet should certainly help WestJet keep its unit costs in check, but it remains to be seen if the multiple other cost challenges can be averted and if the complex revenue strategies will pay off.

By Heini Nuutinen

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