THE STRATEGIC VIEW

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Aviation

2017

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Aviation 2017

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CANADA

Donald Gray and Jason MacIntyre provide an overview of the aviation space in Canada in relation to new market entrants and foreign ownership limitation, alongside an analysis of the effects of reduced oil prices on the national economy

1. Currently, what are the main issues (strategic and political) affecting those in the aviation sector in your jurisdiction?

Record-low oil prices greatly impacted the Canadian aviation market in 2015 and 2016. Although Air Canada and WestJet, Canada's two major airlines, have reported profit increases as a result of the decline in jet fuel prices, the Canadian economy, as an oil-producing nation, has suffered overall as a result of such price decline. This negative impact on the economy has been most acute in Western Canada, where there has been a decrease in air traffic demand for travel to and from energy-focused destinations. The major Canadian airlines have taken a variety of measures to offset the decrease in demand, including decreases in fares and a renewed focus on international network growth. It has also resulted in the airlines extending leases for older, less fuel-efficient aircraft within their fleet, as the relative cost savings for lower fuel consumption have reduced.

Another issue currently affecting the Canadian aviation sector relates to Canada's foreign ownership rules for airlines. Canadian legislation limits foreign ownership of air carriers to 25%, and the Canadian Transportation Agency (CTA) undertakes significant review of transactions and structures to ensure that such limitations are honoured. These limitations have a significant impact on airlines seeking new investments, since at least 75% of investors are required to be Canadian. This has even more impact on potential new market entrants as they seek equity investors, as reported in connection with start-ups such as Canada Jetlines and NewLeaf Travel. There have been a number of media reports over the past year concerning these new entrants seeking exemptions from the CTA to relax the ownership restriction rules, but we are unaware of any exemptions having been granted to date. In 2016, the federal government tabled a report by David Emerson (the Emerson Report), a former cabinet minister, who had undertaken a review of the Canada Transport Act. The Emerson Report recommended that foreign ownership limits for commercial airlines be increased to 49%. The current government is still considering this proposal.

2. Where has your jurisdiction seen the most growth in the aviation sector over the past 12–18 months? And, if any, where do you anticipate growth coming from during the next 12 months?

With Canada's adoption of the Cape Town Convention in 2013, we have seen an increase in capital markets transactions for aircraft financing over the past 18 months. Following its first, and very successful, enhanced equipment trust certificate (EETC) transaction in 2013, Air Canada launched two additional EETCs in 2015 (2015-1 for 9xB787 aircraft and 2015-2 for 3x787 and 2x777 aircraft). The adoption of the Cape Town Convention allowed Air Canada to benefit from investment-grade pricing for the financing of these aircraft, as the Convention provides investors with additional certainty regarding the enforcement rights and judicial regime in the event of an airline insolvency.

The aviation sector in Canada has seen, and will continue to see, increasing growth amongst carriers offering low-cost travel options. In 2013, both Air Canada and WestJet entered this market. Air Canada introduced Air Canada rouge, a low-cost carrier subsidiary that has grown its fleet to approximately 44 aircraft (a mix of B767s and A319s), operating principally on holiday and leisure routes. Air Canada rouge has also seen rapid growth in the number of routes offered and customers served. WestJet entered the regional carrier market with its debut of WestJet Encore as a short-haul regional airline, currently operating approximately 30 Bombardier Q400 aircraft. Additionally, WestJet entered the long-haul market in 2016, offering services to London, England.

Taking the low-cost model one step further, there have been a number of potential market entrants in Canada wishing to offer ultra-low-cost carrier (ULCC) service. NewLeaf Travel Co. Inc., a seat reseller, recently partnered with Flair Airlines and commenced service across Canada, principally operating from underutilised airports. As mentioned above, there are a number of potential new entrants seeking exemptions from Canada's foreign ownership rules in order to raise the necessary equity to start offering ULCC service.

3. Does the GDS distribution model continue unchallenged as the most popular model for flight distribution?

The major Canadian airlines continue to use the GDS distribution model for flight distribution. In September 2015, Air Canada announced it had entered into a multi-year agreement with Amadeus to sell its entire range of services.

4. In your jurisdiction, does airport capacity require boosting and, if so (and even if not), what plans and/or processes are in place to address this (or increase or re-organise airport capacity, as the case may be)?

While, in general, Canadian airports are not particularly capacity-constrained, during peak travel times capacity at Canada's two largest airports, Toronto Pearson and Vancouver International, can be strained.

At Toronto Pearson, demand growth is outpacing its global competitors, with traffic increasing by more than 6% in each of the last two years according to Greater Toronto Airport Authority (GTAA) reports. By 2033, the GTAA expects that Toronto Pearson could handle 65–70 million passengers per year, in addition to growing cargo handling. Currently, the air travel capacity for all airports in Southern Ontario is capped at approximately 70 million passengers, according to a report from the Toronto Region Board of Trade.

The Greater Toronto Airport Authority (GTAA) has recommended a system of regional co-ordination in order to optimise capacity. Other possible capacity increases recommended by the GTAA include terminal expansion and the addition of a sixth runway at Toronto Pearson; however, no concrete plans have been made.

The Vancouver Airport Authority (VAA) anticipates that Vancouver International will reach full capacity in approximately five years. The VAA is currently developing a new master plan and undertaking public consultations about growth strategies. There will likely be some expansion of the passenger terminal in order to increase capacity and meet demand.

5. Does the national "flag" carrier carry the most passengers into and out of the national airports and: (a) if so, what competition exists and how significant is it?; and (b) if not, what are your thoughts on the reasons for this, and why do competing airlines have higher load factors?

Yes, the national flag carrier, Air Canada, carries the most passengers in and out of Canadian airports, accounting for 54% of available seat-kilometres in the domestic air market in 2015 according to Transport Canada's overview report: 'Transportation in Canada 2015'. By comparison, WestJet, Air Canada's main competitor, accounted for 37% of available seat-kilometres in the domestic air market in 2015.

While successful in their niche markets, other airlines such as regional carrier Porter Airlines, and leisure carriers AirTransat and Sunwing Airlines, have not represented serious threats to Air Canada and WestJet's dominance.

6. What trends, in terms of regulatory intervention and involvement, has your jurisdiction observed over the past 12–18 months in relation to airline acquisitions and alliances? Do you anticipate a change in the regulatory environment of your jurisdiction during the coming 12 months, and if so, how?

Other than the various exemptions that have been requested of the CTA relating to the foreign ownership restrictions (discussed above), there have been no regulatory changes or trends in the past 12–18 months relating specifically to airline acquisitions and alliances. There is no expectation of any significant changes to the aviation regulatory environment during the coming 12 months, except for those arising from the Emerson Report discussed above and the proposed UAV regulations discussed below.

One change to the Canadian aviation regulatory environment arose in 2015 relating to the war risks indemnity provided by the Canadian government following the terrorist attacks of September 11, 2001, in the US. The governmental indemnity sought to provide the Canadian air industry with war risks insurance coverage in an amount equal to the general insurance coverage it maintained, which became prohibitively expensive to procure in the commercial market after 9/11. As of June 30, 2016, the Canadian government no longer provides this coverage, requiring all major Canadian airlines to obtain war risks insurance from the commercial market.

7. What trends are being observed in relation to new technologies – such as UAVs/drones – and what impact are these technologies having on the aviation regulatory environment?

Transport Canada Aviation (TCA) regulates the conduct of UAVs for both commercial and private use. In Canada, UAVs must meet the equivalent levels of safety as exist for manned aircraft. In general, Canadian aviation regulations apply to UAVs that have a total weight in excess of 35 kilograms or to UAVs driven or launched into flight for purposes other than recreational use. In

> With Canada's adoption of the Cape Town Convention in 2013, we have seen an increase in capital markets transactions for aircraft financing over the past 18 months

respect of UAVs meeting these criteria, unless the UAV operations qualify for another exemption, a Special Flight Operation Certificate (SFOC) must be obtained from TCA.

In late 2014, TCA issued a staff instruction (SI) and an advisory circular (AC) in respect of UAV operations in Canada to ensure that the SFOC process was more in line with the changing technology of UAVs and the type of operations being conducted with UAVs. The SI, for example, eliminates the need for SFOCs in respect of small UAVs in certain circumstances. While the exemptions created under the SI and AC have assisted in processing the backlog of SFOC applications, the current regulatory regime is incompatible with the rapidly evolving UAV industry.

In 2015, the Canadian Aviation Regulations Advisory Council issued a notice of proposed amendment (NPA) in respect of UAVs. The NPA announced that TCA intended to revise the regulatory regime as it relates to UAVs weighing 25 kilograms or less that are operated within a visual line of sight. There are two main changes: (1) the requirement for such UAVs to be marked and registered with TCA; and (2) the requirement for UAV pilots to obtain a pilot's permit from TCA. A more thorough set of regulations addressing these requirements, together with a more comprehensive regulatory framework for UAV operations, is anticipated to be released in 2017.

8. Legal issues in the "lease-to-part out" market. A major market development is the interest of investors purchasing mid–end life aircraft on lease for the purposes of making returns on a leasetail and component margin model. What challenges are inherent in this segment of the aviation finance market, and what techniques and disciplines are required to manage the risks involved?

There is nothing unique about the Canadian market that would make part-outs particularly difficult. From a legal perspective, the one challenge to be overcome, from the point of view of a buyer, relates

> The Iranian demand for aircraft could once again present an opportunity for Canada to tap into foreign markets for economic growth

to title. Canada does not maintain a title register for aircraft, and there is not one central register where security interests can be registered. To the extent that a buyer has concerns relating to title warranties, a due diligence review of back-to-birth bills of sale would be required. In addition, searches should be conducted at both the International Registry maintained pursuant to the Cape Town Convention and the applicable provincial or territorial Personal Property Registry. There are also a number of liens and rights of detention that may be exercised against aircraft and component parts in Canada (including, without limitation, for arrears on airport charges, air navigation charges, taxes, repair and storage liens and customs duties).

9. Manufacturer support in the new cycle of new OEM products, e.g. MRJ, E2, C-series, etc. In an increasingly sophisticated and competitive environment, in what way is the type of OEM financial and product support for this new era of aircraft more complex and far-reaching than in previous cycles?

One example of financial and product support stems from the challenges faced by Bombardier in its launch of the C-Series jet. After two years of delay, the aircraft is now available for order (though Bombardier reports that the project exceeded its budget by approximately US$2,000,000,000 in the process). In Canada, both provincial and federal governments provide support to Bombardier. Provincially, the government of Quebec supports Bombardier through its programme of export credits and loan guarantees, *Investissement Québec*. Federally, Export Development Canada (EDC), our federal export credit agency, provides insurance and financial services for export trade transactions, facilitating the sale of Bombardier aerospace products to foreign buyers by granting them export credits, loan guarantees or other financial support.

In October 2015, Bombardier approached the Quebec government for assistance and was granted a US$1,000,000,000 investment. In exchange, the Quebec government will receive a 49.5% stake in the new limited partnership. Bombardier has also asked the federal government for an equivalent US$1,000,000,000 in assistance, which has thus far not been granted. The federal government is pressing for changes to Bombardier's corporate governance structure in exchange for its investment, but the manufacturer has objected to the request to modify its dual-class share system. Furthermore, the federal government has indicated that it favours credit financing as opposed to the requested equity participation. The federal government continues to face growing pressure to provide financial assistance to Bombardier and discussions regarding a federal contribution are ongoing.

10. The advent of cheaper oil and the knock-on effects. What are the consequences that arise as a result of the unexpected purchasing power of a number of third/fourth-tier airlines? What will challenge lessors and suppliers in particular as they are faced with speculative judgments on an airline's longer-term financial viability?

As discussed above, Air Canada and WestJet dominate the Canadian aviation space, so any increased purchasing power of third/fourth-tier airlines resulting from cheaper oil would not be expected to have a significant long-term impact on the overall market. In the short term, it could lead to lower flight prices and increasingly competitive rates for airline customers. Of course, the negative effects of lower oil prices on the Canadian economy as a whole have resulted in some demand decreases in the short term, particularly in Western Canada.

11. Iran and the market return. What remain as barriers, including sanctions-related issues to navigate, where Iran and aerospace and aircraft transactions are concerned? What sort of jurisdiction is Iran from a risk perspective, and what techniques from a supply perspective are likely to be needed so that Iran's potential and promise for OEMs, lessors, suppliers and service providers is realised and does not become the latest example of a disappointing gold rush?

Prior to the implementation of successive Canadian sanctions, Iran was one of Canada's most important trading partners in the Middle East. The Iranian demand for aircraft could once again present an opportunity for Canada to tap into foreign markets for economic growth, with a particular focus on the Bombardier product line. However, many hurdles remain, the first of which is whether Iran is able to obtain financing in a market where investors and aircraft financing companies remain hesitant and are treading cautiously. This is in part due to the possibility of a "snap-back" of the sanctions if Iran defaults on the terms of the Joint Comprehensive Plan of Action. Second, the reintroduction of Iran into the global aviation industry will be slow-moving as a whole, due to issues ranging from other demands on the country's capital for improving infrastructure, to the impact of low oil prices on Iran's economy and spending power. Furthermore, several Iranian Airlines, including Meraj Airlines, Caspian Airlines and privately-owned Mahan Air, the largest carrier in Iran, continue to face US sanctions.

It has been reported that both Boeing and Airbus have entered into agreements with Iran Air for the potential sale of aircraft to the airline. However, recent US legislation appears to block these transactions, by introducing restrictions on both the sale and financing of aircraft manufactured in the US. This could present a potential opportunity for Bombardier. This opening in the market, however, could be limited given that Bombardier also uses components manufactured in the US which may be impacted by the US legislation. Bombardier has confirmed that discussions in Iran are already underway.

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