

# Aviation Policy and the Canadian Transportation Act

A brief to the CTA Review Commission

**By**

**The Air Transport Association of Canada**

255 Albert St.  
Suite 1100  
Ottawa, Ontario

**November 17, 2000**

## **A Brief to CTA Review**

ATAC welcomes the opportunity to present its views to the Canadian Transportation Act Review Commission. Commissions of this kind have a major impact on our national debate about transportation because they build both a knowledge base developed through research, and also a consensus among operators and policy makers as to the appropriate governmental responses to the challenges of each era.

The Commission will not merely study the workings of the Act, it will also evaluate the policies reflected in that legislation. In our brief we will therefore discuss not just the specifics of the statute but also the overall policy context in which the Review is taking place.

The CTA Review comes at a time when two important questions are being debated in the airline sector.

Firstly, has the trend towards market forces and away from government intervention run too long? Do circumstances call for aggressive government action?

Secondly, aside from direct regulation of the market, what are the priorities for government action in the coming years?

To the first question; do circumstances call for more government intervention to assure service, employment and price stability?

There can be no doubt that the preponderance of policy debate in the 1980s and 90s centered around the role of market forces in shaping our transportation services.

In 1985 the discussion paper “Freedom to Move” signaled the government’s intention to bring market forces to bear on the transportation sector by arguing customers should be permitted to exercise freedom of choice (confidential contracting) and operators should be allowing to compete (freedom to enter and exit market based only on a “fit, willing and able” test) to meet customer demands. In 1993 NTA Review Commission extended the argument; recommending that government finish the deregulatory process by releasing operators from myriad governmental constraints and intrusions including its ownership of Canadian National, various transportation subsidies, and constraints on freedom to enter and exit markets north of 60. The Royal Commission on Passenger Transportation made similar, sweeping recommendations.

But these reports were all tabled during a period of intense concern about federal deficits. Crown spending in transportation was falling. Industrial competitiveness was clearly at risk. Today some voices are asking if the end of federal deficits should signal a renewed era of governmental activism in transportation.

ATAC strongly argues that this would be counterproductive. In fact, it would deprive Canadian consumers of the innovations and improvements the air transport community will otherwise produce.

The Review is taking place during a tumultuous time in air transport.

- The restructuring of Air Canada and Canadian Airlines continues to affect thousands of employees and millions of customers.
- In response to this restructuring, the government has passed c-26, the most significant transportation legislation since the passage of the CTA in 1995.
- In the market many carriers have responded to the restructuring by launching dramatic expansion efforts, in some cases doubling the size of their fleets.
- Just as significant as these fleet decisions, many carriers have commenced major changes to their business strategies; moving from charter to scheduled service and opening service to transborder markets. A substantial segment of the industry now offers discount service.

It is important that the Review understand the significance of these trends. The airline sector that is emerging in Canada is markedly different from the one which dominated our industry for the past decade.

Like most countries, Canada is a signatory of the Chicago Convention, the international civil aviation accord which defined how airline services would evolve though the 1940 to the 1980s. Central to the Convention was the role of a single, usually government owned, “national carrier.” For decades Canada’s flagship airline was Air Canada, which was owned by the government. The assumption was that this carrier should serve virtually every kind of aviation market.

When deregulation unleashed competitors, PWA/Canadian Airlines aggressively sought to compete with Air Canada in each of the markets the former Crown corporation served. Both were “full service” carriers operating scheduled, charter, cargo, transborder and international services. Both purchased or built families of regional feeder airlines. This competition across all markets was not a successful business model for the air carriers involved, though it provided consumers with extraordinarily high service levels. For an entire decade these two carriers fought for every region and type of customer, recording anemic returns or outright losses.

With the demise of Canadian, the airline sector has become dominated by a single carrier, with a wide range of competitors serving specific, narrow market niches. ATAC regards it as highly unlikely that we will soon see a new competitor emerge to repeat the business strategy of contesting the entire market. Rather we anticipate strong growth by carriers who select areas in which they can be highly competitive without excessive risk.

Should this be a matter of concern to government? There's no doubt consumers benefited from the ubiquitous competition of the two largest carriers. But the business situation was, as we have seen, unstable. Extraordinary efforts had to be made by governments to support Canadian Airlines. When it finally was unable to continue, investors and creditors suffered.

So, although competition is an essential feature of a healthy industry, the business strategy featuring two carriers fighting to be dominant in all markets was not a success. The emerging structure of the industry post-Canadian will likely be quite different.

With Canadian gone, others are growing:

- In 2000 Air Transat is approximately 50% larger in the domestic market than it was two years ago.
- In February Westjet ordered 30 new jet aircraft, and made arrangements to order up to forty more over the next several years. By January 2001 the carrier plans to be serving 16 Canadian cities.
- Royal Airways obtained new aircraft and launched scheduled service in the eastern triangle.
- Canjet commenced service from Halifax to five cities.
- Canada 3000 completed a major financing and placed orders for five A319 aircraft.

In markets across the country smaller carriers are opening new services and employing additional staff. Competitive options exist in more and more communities.

In part this reflects our growing economy. If economic growth slows, so will the pace of carrier expansion. But the market is demonstrating that it continues to work in Canada.

### **Cost is king**

The new airline market will look quite different from the warring houses of the 1990s, at least for a time. Most strikingly, the market now features a number of carriers – the largest competitors to Air Canada – who offer low costs and modest service.

Discount carriers provide mobility at a low cost. To do so they eschew conventional amenities such as food services. They do not interline with domestic or international allies, nor do they serve congested hub airports. They don't offer frequent flyer programs. They typically do not cross international borders and so avoid the complexities of immigration and custom laws. Their fleets are composed of only one or two aircraft types, to keep maintenance and training costs low and increase crew flexibility. They are often not unionized.

Clearly this restrictive profile is a challenge from a marketing viewpoint. The full service carrier offers more to the consumer - the only weapon the discount carrier has to attract customers is price – low price. The vast majority of travelers on the low cost airlines are paying for the journey themselves using discretionary, after-tax income. They differ from business travelers who are less price sensitive and more willing to pay for service amenities.

That price isn't just lower than the full service competitor, it's critical that it be inexpensive relative to the average person's income. These carriers are at a disadvantage when appealing to high-demand business travelers. They prosper by inducing travel among those who might otherwise have taken a car or a bus...or not gone at all.

*This is an overriding reality in today's aviation market – control of costs is central, not just to carrier profits, but to their survival and growth. Viable competition, so important to consumers, depends on government understanding the economic basis for the companies which will provide that competition.*

ATAC sees evidence today that these economic facts are not well understood in all circles of government. A government bent on stimulating domestic competition would, in light of the factors discussed above, make every effort to reduce operator costs. Instead we see a steady upward trend in carrier costs and many of these are direct products of government decisions.

- Fuel Tax

Ottawa, almost alone among Canadian jurisdictions, has refused to reduce its fuel tax on aviation fuel. More than \$80 million annually is levied on carriers and their customers through an antiquated excise tax which has been reduced or eliminated in most provinces. Despite improved government finances this tax, which impacts smaller carriers more than the larger operators, remains unchanged.

- Airport Security Screening

The federal government has compelled the industry to assume control and costs of security infrastructure costing the industry about \$3 million annually.

- Airport Policing

Because of changes in obligations imposed on airports and their users, the industry now pays between \$15 and \$20 million more for airport policing than it did in the mid 1990s.

- User fees

Transport Canada has moved to impose fees on a wide range of services and products, generally items which aviation businesses have no

choice but to purchase. User charges now account for approximately \$20 million annually.

ATAC brings these items to the Commission's attention not so much to debate the particulars as to illustrate a trend. Government always has competing priorities; it is clear that the need to stimulate competition by aiding smaller carriers to grow is losing to the traditional government need for ever-greater revenues.

## **National Airports Policy**

ATAC draws the Review Commission's attention to the urgent need for an airports policy which is coherent and consistent with the Canada Transportation Act. Canada's current airports policy – the National Airports Policy 1994 - remains a significant concern in the development of our airline sector. We note that the federal government's responsibilities with regard to airports is nowhere made clear in the CTA and we urge that this deficiency be identified in the Commission's report.

Announced in haste in the summer of 1994 without any consultation with airlines, provinces or municipalities, the policy set forth a plan to shift virtually all federal airports to new management; smaller airports would be known as regional and sold to municipal authorities, the largest 26 would remain federal institutions but would be managed by local authorities and would pay rent to the federal government.

ATAC strongly supports the decision to devolve airports out of federal management. The innovations introduced by airport authorities have improved service and returned competitiveness to a sector which was lagging behind world standards. The major capital projects undertaken in most cities were critically needed and probably would not have been undertaken under the government's management.

Nonetheless, we have a variety of criticisms of this policy related to its implementation.

The key deficiencies of this policy are simple enough and illuminate some important features of transportation policy.

- Department of Transport lacks personnel with the economic expertise to craft policies in the modern era. In the airport devolution process, for example, the Department created a lease agreement which is unlike any in use in commercial circles. In setting the rental rates for these leases government officials constantly cited a duty to secure a "fair return on investment" for taxpayers, but seemed incapable of saying what specific return was sought, or what is meant by the term investment in government accounting. This term, which has a specific business application, is used to

explain a program based essentially on the argument that since taxpayers had paid a lot in the past, travelers should pay a lot now.

- There is no mechanism for altering the program on a national scale. Each alteration has been privately negotiated with specific parties. Not surprisingly this had produced differences in treatment which seem quite unfair. Moreover the dialogue between industry and department continues to be confrontational. There was no consultation before the policy was announced in 1994 and it is plain that key features were designed in error. This style of public administration sharply contrasts with Departments such as Revenue Canada which continually adjust procedures as practitioners give their input.
- Transport Policy is still quite modal in its approach, a legacy of an operational role the government no longer performs. Airport devolution demonstrates how inconsistent policies are; Canadian National was sold outright, and taxpayers received a single sale price. Similarly NavCanada was sold in a single transaction with the Crown enjoying no ongoing financial benefit. However the airports were devolved through a torturous lease negotiation process which produces hundreds of millions of dollars in rental payments each year, an amount which rises annually.
- Programs seem little connected to the policy direction for Canadian transportation set out in the policy section of the CTA. For example, the National Airports Policy described above seems to have no regard to article e. which states

**“(e) each carrier or mode of transportation, as far as is practicable, bears a fair proportion of the real costs of the resources, facilities and services provided to that carrier or mode of transportation at public expense.”**

Since the Auditor General recently concluded that Transport Canada had never satisfactorily valued its airport assets before transferring them, and since its will recoup many times the value of those assets while providing no services, the structure of the National Airports Policy is clearly inconsistent with the CTA.

As it withdrew from operations and devolved its assets, Transport Canada embarked on a sharply different future, one for which it is not well equipped. Rather than an operational organization which directly participates in transportation, the Department is now a overseer and must become a policy architect. The NAP is a test case for the new challenges the Department must confront.

## **Cabotage**

Distressed that the two-full service carrier model has failed and concerned that they may be at the mercy of a near-monopoly, many commentators have suggested that Canada “open its borders” to permit US carriers – to serve point to point within our borders; a situation known as cabotage. Various modifications on this theme have been postulated; modified six freedoms, right of establishment, etc.

The prospect of new competition delivered instantly to solve our airline problems is a seductive notion. ATAC expects the Commission to receive a number of submissions recommending this approach. And there is no question that it should receive careful scrutiny, but like most instant solutions, it does not live up to its promise.

ATAC believes that there could be benefit to Canada in a negotiation about continued expansion of the reciprocal freedoms Canada and the United States offer each other. Our last major agreement, Open Skies, has proved beneficial to carriers and consumers.

However we vehemently oppose the suggestion that Canada should unilaterally offer cabotage rights to US carriers. To do so would cost many thousands of Canadian jobs and benefit relatively few consumers.

The Commission should note that no country in the world currently permits cabotage. With good reason; airlines constantly press to increase the efficiency of the network systems. These are built around strategically located airport hubs with the most powerful hubs inevitably emerging in locations which are most central in the network and most populous. Hence Toronto is our most important hub for domestic travel and Vancouver is a smaller but still important hub within the Pacific Rim market.

Canada should certainly not be the first, given our geography as a narrow band of population lying atop the dense US aviation market. The effect of a completely open border would be to extend the catchment areas of the northern US airport hubs – Chicago, San Francisco, New York, Pittsburgh to absorb an enormous percentage of Canadian traffic. This would marginalize the role of Canadian airports as US carriers would decline to invest in people and facilities in Canada, preferring to add route options from their existing networks in the US.

Cabotage would also immediately end the competitiveness of Canadian carriers in the the transborder market, since the US carriers would have unlimited route flexibility in both countries and Canadian carriers would be constrained to point/point service.

There is a technical issue which the Commission may want to examine; under Article 7 of the Chicago Convention states may not offer exclusive cabotage rights to another country. If Canada decided to open its border it might be required to do so for carriers of any country.

Some may argue that Canadian carriers and airports are a relatively small price to pay for the general benefit to Canadian consumers. It's important that the Commission consider carefully which markets US carriers would choose to serve north of the border. Clearly the most attractive – the only attractive – routes would be OD services between the largest cities. But these are the markets which already have attracted the competitive efforts of carriers like Westjet, Canada 3000 and Royal. Consumers traveling between Halifax and Ottawa, for example, can already choose between Canjet, Westjet, Air Canada, Canada 3000 and Royal.

Accordingly, ATAC recommends that the CTA Review Commission take a firm stand; the appropriate policy for Canada is not unilateral surrender of the jobs and revenues supported by our domestic industry, but a stimulation of that domestic industry by appropriate fiscal and infrastructure policies.

### **Bill C-26**

Specific aspects of this legislation should be of interest to the Commission. C-26 was conceived as a reaction to the market dominance of Air Canada.

Some legal experts have argued that few, if any, of the Bill's provisions were necessary since the government had the ability to effect virtually all of the legislation's goals with the laws in effect already. The Bill, in keeping with the tradition in transportation legislation, did not establish right and wrong so much as it strengthened the powers of many public officers to investigate and take decisions about mergers, pricing, market exit and foreign investment.

ATAC supported the legislation, albeit reluctantly. Our membership shared the government's concern about the dominant position occupied by Air Canada. However we argued strenuously that Parliament should compel many of these office holders to detail how their powers would be applied before the legislation was passed. Only the Competition Bureau responded with a description of the criteria it would use to review circumstances before intervening.

Since the extraordinary powers granted to officials were crafted to meet a specific threat – possible abuse of dominance by a single carrier – the Commission should urge the government to establish specific sunset provisions in the Act to withdraw those powers when the dominance declines. This tailoring of the Act was included in one specific provision – the right of travel agents to negotiate “collectively” – and this right will be withdrawn as soon as the dominant carrier represents less than 60% of domestic passenger travel.

ATAC urges that the Commission call for similar sunset provisions in other aspects of the law.

## **Conclusion**

Although the aviation industry in Canada has experienced a traumatic period, there is evidence that the market forces, which are specifically identified in the CTA as the prime shapers of transportation services, continue to operate. The logic which persuaded generations of policy makers, ranging back to the early 1960s, to allow those market forces to act with increasing freedom is still valid today.