AIR CANADA

COMMENTS ON PAPERS SUBMITTED TO CANADA TRANSPORTATION ACT REVIEW PANEL

April 18, 2001

A. INTRODUCTION

Air Canada is pleased to offer the following thoughts and observations on several papers and draft papers submitted to the *Canada Transportation Act* Review Panel. Given that these papers raise issues of significant importance to Air Canada, the Canadian airline industry and the Canadian public, we thought it would be important to comment and give our views on several of the specific issues raised in the papers as well as provide some more general views which we have taken the opportunity to express here.

Overall, Air Canada believes that additional layers of regulation, bureaucracy and resulting costs would be a step backward and highly undesirable at this critical point in time as the airline industry moves more and more towards international competition.

Air Canada does however, recognize the necessity for additional clarity with regard to specific issues and, in particular, would encourage the following:

(a) further analysis and recognition of the impact of the substantive provisions and processes put in place by Bill C-26, and its effect on competition in the Canadian airline industry and on Air Canada;

(b) elaboration on the meaning of “avoidable costs” in the context of predatory pricing. In view of the fact that we are now faced with an extremely dynamic competitive marketplace that has not yet found its equilibrium, it is important for Air Canada to know the rules of the game;

(c) recognition that Air Canada, and its domestic competitors, need to compete on as level a playing field as possible with US and international competitors and therefore require an infrastructure which will allow them to do so;

(d) refinement of an airport policy that would allow Air Canada to compete externally (primarily with US competitors) and internally without being hamstrung by the imposition of excessive and uneven costs; and

(e) an early review of Canadian Transportation Agency ("CTA") policies and legislation as they relate to the airline industry with the benefit of experience gained under the provisions of Bill C-26.

In the sections to follow Air Canada will address the following specific issues: the state of competition and regulation in the Canadian airline industry, suggested measures to increase competition, the performance of Canadian carriers and the role of airports and airport authorities.

B. COMPETITION IN CANADIAN AIRLINE MARKETS

1. State of the Canadian Airline Industry

(a) General

In "Policy Proposals for Enhancing Competition in Canadian Airline Markets" (Initial Draft), a study prepared for the *Canada Transportation Act* Review Panel, March 11, 2001, the authors, Professor T.W. Ross and Professor W.T Stanbury note that that some observers do not think that the domestic market can support two national network carriers.[1] The situation is even more complex than that. It is difficult to tell what the equilibrium configuration of any particular city pair market might be. That is, we do not know how many and what kind of carriers each route can support. We do not know how much competition there can be. Moreover, this industry is highly cyclical and also sensitive to the prices of key inputs such as fuel. The amount of competition that various city pair markets can support could vary significantly over time. Given that, as the authors concede, various forms of niche entry or market extension are relatively easy, it is likely that the industry will be characterized by a continual round of entry, amalgamations and bankruptcies regardless of what the dominant incumbent does.

In addition, the industry is characterized, as are most transportation industries, by a significant gap between average and marginal cost. Competition to fill excess capacity during cyclical downturns can result in large fluctuations in yields.[2] So we have a market in which price-cutting in various forms and economic difficulties will be, if not the norm, at least much more common than in other industries. It is going to be very difficult to infer the marginal impact of predatory behaviour in this context.

(b) Air Canada's Position in the Canadian Airline Industry

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[1] Stanbury and Ross, p. 2-6.
[2]The authors allude to this on p.3-33.

Stanbury and Ross tend to overemphasize and misinterpret Air Canada's "dominance" in terms of capacity, market share, revenue, fleet size and state of competition. On several occasions, the authors refer to a "monopoly on 120 of 200 routes." These kind of statements are misleading, and Air Canada would like to take the opportunity here to clarify the situation. Many of the "monopoly routes" that Stanbury and Ross refer to are very small routes in terms of revenue generation that no competitors are particularly interested in serving. Even before the recent expansion of WestJet and Canada 3000, Air Canada had competition on 72% of routes that are operated by Air Canada mainline (Air Canada mainline accounts for approximately 87% of all Air Canada revenue). With the expansion of competitors, this figure has probably increased. This competition is not insignificant either. The inroads made by large competitors such as WestJet and Canada 3000 have resulted in lower Air Canada capacity shares on many key routes. For example, the current Air Canada capacity share on Toronto-Halifax is 57%, Montreal-Toronto - 56%, Winnipeg-Calgary - 44%.[3]

In terms of domestic seat capacity on Air Canada mainline routes, Air Canada accounted for 77% of all such capacity in the peak period of 2000. Current estimates for the peak period of 2001 indicate that Air Canada seat capacity will only be 62% of all seat capacity in these markets. This represents an increase in competitors' seat capacity from 23% in 2000 to 38% for 2001, or an increase of 87% on a year-over-year basis.

The Canadian airline industry has, since the merger of Air Canada with Canadian Airlines International Ltd. ("Canadian") witnessed expansion by competitors on existing routes (WestJet, Royal, *etc.*), a number of new entrants in many individual markets (WestJet, Canjet, RootsAir, Royal, HawkAir, *etc.*), some consolidation resulting in a stronger competitor (Canada 3000, which now encompasses all of Royal and Canjet's flights), and constant changes in the state of competition throughout Canada. This activity goes to refute the suggestion that Air Canada has a chokehold on the industry and also demonstrates that the barriers to entry are minimal.

2. Regulation of the Canadian Airline Industry

(a) Generally

The airline industry has been recently subjected to new price, merger and exit regulations. In paragraph 3.2, Stanbury and Ross note that the merger review process which Bill C-26 provides is hugely elaborate, fundamentally political and does not define the public interest. They seem to take mild exception to this.

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[3] All numbers in this section are based on Air Canada's estimates.

The authors do not, however, examine the implications of these new regulations for the efficient operation of airline markets and for other aspects of the regulatory process. For example, how do limitations on the ability of an incumbent to abandon a route when a new entrant appears affect Stanbury and Ross' view of what constitutes predatory pricing? What will happen to the incentive of new carriers to enter various city pair markets if the CTA requires, on complaint, or on its own volition, requires Air Canada to make significant fare reductions on allegedly non-competitive routes?

(b) **CTA Regulation**

Stanbury and Ross discuss the issue of CTA regulation in their paper. Air Canada's principal comment here is that more analysis on this issue should have been conducted, given the significance of such regulation to the effective operation of the industry.

At p. 3-10 of their paper, Stanbury and Ross state: "The idea that price-cap regulation – as the CRTC does for local telephone rates – could be applied to Air Canada may be simply mistaken. That is one wine that will not travel well to Canada's domestic airline market." Air Canada agrees with this view, but would point out that, regrettably, it appears that regulation of its operations is headed in this direction. For example, the recent CTA Prince Rupert decision ruled that Air Canada's year-round excursion fare on the Prince Rupert-Vancouver route was too high, and that it must offer a fare on this route comparable to its L14VALU fares offered on the Winnipeg-Saskatoon route. What is suggested by this ruling is that fares on allegedly non-competitive routes have to be the same as fares on allegedly similar and allegedly competitive routes, and that this is the natural order of things. In fact, the CTA clearly states its opinion that the intent of section 66 of the *Canada Transportation Act* (the "Act") is to ensure that travellers on non-competitive routes are offered fares which are substantially comparable in level and range to those offered to travellers on competitive routes. Air Canada disagrees with this interpretation. The fact that fares would typically be somewhat lower on routes where there is vigorous competition is consistent with basic economic theory.[4]

There are several reasons why it would be inappropriate for the CTA to impose equal fares across what it regards to be similar routes. By the way of summary, however, Air Canada would like to highlight the following reasons:[5]

- Suppressing fare differences between routes distorts market signals on the supply side. Low fares deter market entry while high fares tend to attract it.

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[4] Similarly, there are few if any market models which do not predict that the entry of new capacity into a market pushes down the price in that market.
[5] These are similar comments to those made in the past by Air Canada to the CTA.

An order requiring a carrier to publish and apply a fare on an allegedly "non-competitive" route, which is being applied on a "competitive" route, falsely signals to potential entrants on the allegedly "non-competitive" route that it should not bother, and hence denies a competitive option to consumers;

- The effect of differences in the competitive characteristics of allegedly comparable routes cannot be suppressed by regulatory fiat. If the CTA were to order a price reduction on a route where there is no excess capacity, then an issue would arise concerning who would get the seats available on the route since the seats would no longer be rationed or allocated by a willingness to pay. Without new capacity, someone valuing a seat more highly (someone with more pressing reasons to travel) might find that there were no seats available. Consumers would simply be misinformed, as the lower fares would falsely signal increased supply and hence consumption opportunities that do not exist. Furthermore, one must also ask from where the additional capacity would come to meet demand. This is particularly the case in small, low-traffic communities where, given that the capacity increases in the airline industry occur in the form of a step function (*i.e.*, by plane rather than individual seats), a proportionally larger increase in demand is required to justify the addition of capacity than in larger, higher-traffic communities;

- The Canadian airline industry is currently in a state of flux, with new entrants introducing domestic services. Given this competitive environment, it is particularly important that the CTA not use its regulatory powers to distort market signals, and jeopardize the potential success of new entry;

- It is essential that an incumbent carrier be allowed, indeed encouraged, to reduce fares on a particular route, provided it is not predatory. If the incumbent is obliged to offer comparable fares on all routes, or on all allegedly similar routes, it may simply forego lowering fares on any route in the first place (*i.e.*, it will have reduced incentive to respond to the price initiatives of its rivals). The rivals will, in turn, raise their prices. The result could be monopoly prices on both the "competitive" and allegedly "non-competitive" routes. Regulation will have subverted competition rather than having promoted it, contrary to the national transportation policy set out in section 5 of the *Act,* which mandates that the objectives of the national transportation system are most likely to be achieved under conditions ensuring that, among other things, competition and market forces are, whenever possible, the prime agents in providing viable and effective transportation services (subsection 5(b)); and

- It is not unreasonable, from an economic perspective, for an airline to publish and apply a fare on a competitive route, but not to apply that same fare to an

allegedly non-competitive route. The Act was intended to address the adequacy or inadequacy of ranges of fares, or the reasonableness or unreasonableness of fares. Requiring Air Canada to offer identical fares on certain routes as it does on others would set a precedent that would surely act as a disincentive to competition, and would be harmful to consumers.

If the Prince Rupert decision is sustained it is questionable whether we are really that far away from a re-regulation of the fare-setting activities of the airline industry. It is clear from a review of the Standing Committee on Transport's *Restructuring Canada's Airline Industry: Fostering Competition and Protecting the Public Interest* and the Government of Canada's response to this report, that re-regulation of this sort is not thought to be appropriate.[6]

Air Canada notes that Section 43 of the CTA provides that the Cabinet may, at the request of the CTA or of Cabinet's own motion, issue policy directions to the CTA concerning any matter that comes within the jurisdiction of the CTA. Through such directions, Cabinet would be able to indicate how the new provisions in Bill C-26, as they relate to the CTA, ought to be interpreted and applied, without having to formally amend Bill C-26.

Air Canada therefore would recommend that the Review Panel seek to have Cabinet direct the CTA on certain key issues concerning the application and interpretation of the new powers given to the CTA under Bill C-26. In particular, it could seek to have Cabinet direct the CTA on the following issues:

(i) advising the CTA that section 66 of the Act is not intended to ensure that travellers on "non-competitive" routes are offered fares which are broadly comparable in level and range to those offered to travellers on "competitive" routes, as alleged by the CTA;

(ii) related to the above point, the CTA could be directed that in its assessment of the reasonableness of Air Canada fares, the interests of Air Canada should be taken into account, as well as the interests of the travelling public. It has been held by Canadian courts, who have interpreted the word "reasonable" as found within prior legislation and other similar legislation, that a regulator must take into account not only the public's interest, but those of the regulated entity as well;

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[6] "Rather than returning to a strict regulatory environment, the Committee believes that the most appropriate way to foster competition and protect the public interest is to remove, or to significantly lower, these barriers to participation in the marketplace." (Restructuring Canada's Airline Industry: Fostering Competition and Protecting the Public Interest, Report of the Standing Committee on Transport, December 1999)

(iii) that, prior to issuing any order with respect to any complaint, the CTA must consider changed circumstances between the time a complaint was initiated and a decision is rendered. For example, if a non-competitive route is no longer an non-competitive route at the time the decision is rendered, then the CTA should not issue a decision;

(iv) that the CTA should not issue any orders which would force Air Canada to act in a manner inconsistent with any Competition Bureau orders or directions, or result in Air Canada committing an anti-competitive act, within the meaning of the *Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service*; and

(v) that the CTA should not order Air Canada to take any action which, in the CTA's opinion, could result in harm to a competitor (*e.g.* the situation we are potentially facing with HawkAir on the Prince Rupert-Vancouver route).

These are only some thoughts concerning the content of possible directions to the CTA. These thoughts would have to be developed further, if it is decided that such an initiative would be worth pursuing. Air Canada would be willing to make more detailed submissions on issues that the Cabinet should consider directing the CTA on, if and when that is appropriate.

Stanbury and Ross point out at p. 3-9 that “the CTA can now only regulate fares on monopoly routes and then only upon a complaint”. First, it must be pointed that the CTA currently has the ability to regulate fares on its own motion. Second, it is clear that the number of CTA fare reviews (primarily as a result of complaints) is not insignificant and that such reviews are increasing in frequency. In fact, there have been more than 20 such complaints forwarded to Air Canada for response. Further, the Prince Rupert decision has appeared to prompt others to complain as Air Canada has seen an increase in the number of complaints since this decision.

Stanbury and Ross, at p. 3-10, discuss the “undue discrimination” provision of subsection 67.2(1) of the Act, and they state “we wonder whether this provision permits the CTA to regulate “fences” used by air carriers to control the use of discount fares... Without such fences, however, it would be almost impossible for the airlines to practice price discrimination (yield management) in the fashion they do now.” Air Canada has recently addressed a complaint regarding its prohibition against “back-to-back” ticketing. The CTA, by asserting jurisdiction over this particular matter, at least appears to be taking the view that it can control “fences”. This case has enormous financial consequences for carriers generally. The authors should consider the negative implications of CTA intervention into a carrier’s yield management system.

It is curious that the authors lament the limitations of the CTA as a price regulator (p. 3-14) while elsewhere in their study the authors conclude that fare regulation is impractical and inappropriate in a dynamic industry (p. 5-5; p. 5-11) and express concern that the powers granted to the CTA under C-26 might be used for price regulation (p.4-9).

(c) **Predatory Pricing Regulation/Cease and Desist Orders**

Stanbury and Ross, at page 3-18, examine the amendments to the Competition Act. With the exception of one provision, the authors are very keen on the cease and desist power accorded the Commissioner in section 104.1 of the *Competition Act*. They recommend that if it is found to be unconstitutional, it should be replaced by something promptly. The new section 104.1 of the *Competition Act* provides that:

> 104.1 (1) The Commissioner may make a temporary order prohibiting a person operating a domestic service, as defined in subsection 55(1) of the *Canada Transportation Act*, from doing an act or a thing that could, in the opinion of the Commissioner, constitute an anti-competitive act or requiring the person to take the steps that the Commissioner considers necessary to prevent injury to competition or harm to another person if
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> *(a)* the Commissioner has commenced an inquiry under subsection 10(l) in regard to whether the person has engaged in conduct that is reviewable under section 79; and
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> *(b)* the Commissioner considers that in the absence of a temporary order
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> (i) injury to competition that cannot adequately be remedied by the Tribunal is likely to occur, or
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> (ii) a person is likely to be eliminated as a competitor, suffer a significant loss of market share, suffer a significant loss of revenue or suffer other harm that cannot be adequately remedied by the Tribunal.

With respect to this latter requirement in subsection 104.1(1)(b)(ii) that the competitor suffer "harm that cannot be adequately remedied by the Tribunal" the authors suggest that the irreparable harm requirement is "... harm to competition as a social process for allocating scarce resources in a dynamic economic environment. This requires that the incumbent acquire a sufficiently strong reputation as a 'tough competitor' that efficient potential entrants are deterred from entering the routes in question or other routes ..."[7]

The authors argue that a significant loss of revenue by an entrant is not the same as injury to competition (p. 3-21). They confess to be troubled by the appearance of this test in section 104 and conclude that this is not good policy (p.3-

[7] Stanbury and Ross, p. 3-22.

25). Indeed, Air Canada believes it is not. The implication is that the authors would not find a significant loss of revenue, in itself, sufficient grounds for issuing a cease and desist order. Madam Justice Simpson found that the Commissioner's cease and desist order issued to protect CanJet was justified by subsequent evidence that CanJet made less money than it could have had Air Canada not offered its L14EAST fares. Presumably, Stanbury and Ross do not find this should be a sufficient basis upon which to issue an order.

Stanbury and Ross refer repeatedly to the reputational effect of being known as a tough competitor. They suggest that if this deters entry by efficient competitors it is a bad thing. On the other hand, elsewhere in the study (p. 5-8) they state that it is a good thing for Air Canada to be a tough competitor.

The authors rely heavily on the reputational effect as the basis for their expectation that a dominant incumbent is likely to respond to entry in a predatory manner. The idea is that predatory conduct is costly (by definition) but you only have to do it once because you have fooled others into believing that you will do it again and again when, in fact, you would not. The authors cite theoretical literature which they say supports their view. This theoretical literature relies on some strong assumptions about the extent to which the theoretical victims are uninformed (the authors recognize that incomplete information is an essential part of these models (p. 4-5)). The hypothetical victims in these models are financed by venture capitalists who cannot tell why their investment is doing badly. Victims are not sure whether they are doing badly because of the state of the market or the actions of the dominant incumbent. Victims are not sure whether the incumbent is more efficient or not. Victims are not sure whether the incumbent has an otherwise irrational "taste" for preying or not. Air Canada submits that the question should be asked whether these assumptions of victim ignorance have any grounding whatsoever in the current context. In particular, what happens to these assumptions when the alleged predator is a publicly traded company whose shareholders do not like to lose money any more than anyone else and whose efficiency or lack thereof has been much studied (see the many studies by Dr. Oum). What happens when the entrants are expanding out of market niches and know the market intimately? What happens when new entrants do not have a significant agency problem – that is, when ownership and control are integrated?

Stanbury and Ross make the case for allowing the government to obtain cease and desist orders quickly (p. 3-22). They argue that it is essential to stop predatory pricing virtually before it occurs: "We believe that quick action on the part of the Commissioner of Competition, by way of a temporary injunction, to protect smaller airlines from actions that might be predatory is sometimes going to be necessary." (p. 4-6) Their reasoning is that a dominant incumbent can eliminate an entrant quickly and this will, in turn, deter other entrants thereby lessening competition.

It has not been demonstrated that a dominant incumbent could eradicate a properly financed, efficient entrant quickly or at all or whether it would even attempt to do so. Because of the inefficiencies inherent in protecting inefficient entrants, it is preferable to wait to see what actions the alleged predator actually takes and what effects these actions have had on efficient competitors and competition and then taking enforcement action. While some competitors may not survive, if the enforcement decisions are appropriate, subsequent predatory acts will be deterred and the competitive process will be preserved. Given the difficulty of distinguishing aggressive competition from predation ex post (which the authors acknowledge) and the much greater difficulty of distinguishing a competitive from a predatory action before the action is even put into effect, it might be expected that the authors would see merit in waiting for more information. However, it does not appear that they do.

The authors argue that ex post enforcement is not a viable option. The reason is that the law is badly drafted (in their view), the enforcement process is slow and the Commissioner of Competition has difficulty obtaining convictions. In essence, the authors are arguing for pre-emptive injunctions against actions that benefit consumers and may be pro-competitive, not because this is an intelligent or even workable approach, but on the grounds that existing provisions for ex post enforcement are not well-designed or do not function well and, notwithstanding considerable changes to the *Competition Act*, they cannot be changed or could not be changed in time to meet the political requirements of the government.

Referring to the Competition Bureau's Draft Enforcement Guidelines, Stanbury and Ross say that: "We believe the Bureau has attempted to strike a good balance between economic theory and practicability and clarity for those subject to the new law." It is Air Canada's view that the Guidelines are onerous and burdensome and that there are significant problems with the approach outlined in the Guidelines. For example, the Bureau has not indicated how a potential remedy may work in a predatory situation.

(d) **Avoidable Costs**

The issue of "avoidable costs" will be considered by the Competition Tribunal in the near future. Air Canada is still very much at odds with what the Competition Bureau has deemed to be avoidable costs in the airline industry. Stanbury and Ross do not appear to have considered in any depth the Bureau's "avoidable costs" approach. This is unfortunate as the determination of the avoidable costs issue will have a major impact on how all carriers who may be dominant in a particular market will be able to go about their business.

Although Air Canada will have the opportunity to make detailed submissions to the Competition Tribunal concerning the issue of avoidable costs, it

will take the opportunity here to indicate that it has difficulties with the Bureau's assessment of Air Canada's avoidable costs on a per flight basis as opposed to an examination of a route that operates as part of a network airline. The Bureau's assessment ignores the reality of operating a network. Air Canada also fundamentally disagrees with the Bureau's suggestion that certain particular costs (*e.g.*, ownership costs) are avoidable over the limited period of time that is in issue.

(e) **Barriers to Entry**

Stanbury and Ross, at p. 2-6, remark that: "In general terms, there appear to be very high barriers to entry (or expansion) for any carrier proposing to become a large-network carrier like Air Canada." Air Canada would note that frequent new entry into markets over the course of the last two years (WestJet, Canjet, Royal, RootsAir, Hawkair *etc.*) demonstrates that barriers to entry are not substantial. As far as there being barriers to becoming a "large-network carrier like Air Canada", this is a bit like saying that there are barriers to becoming one of the "Big Three" automakers. Certainly, the development, over time, of a large domestic and international network like that operated by Air Canada is not an easy task and it is not reasonable to suggest that this could be done overnight. The business and competitive reality of the airline industry is such that entrants attempt to identify and exploit markets on a niche basis and aim for steady growth. However, Air Canada does not believe that there are any systematic barriers to expansion or growth and the success of carriers such as WestJet in Canada and SouthWest Airlines in the United States is evidence of that.

It should be noted that while there are no significant barriers to entry or expansion, there may be, however, constraints due to the small size of the Canadian marketplace. That is, it is certainly not clear that Canada is large enough to support two or more large-network carriers over the longer term.

3. Suggestions of Anti-competitive Activities

The authors of several of the papers and draft papers submitted to the Review Panel offered their suggested measures to increase competition. Our comments on these measures follow.

(a) **New Entrants**

At p. 2-18 Stanbury and Ross state that CanJet's start-up "was delayed until September 5, 2000 when Air Canada immediately matched its lowest fares." This implies that the startup of CanJet's operations was delayed because of price-matching. Air Canada is not aware of any delay in CanJet's start-up timeline. According to the CanJet website, CanJet first announced routes and fares, in a press release titled "CanJet Airlines Introduces the Smartest Way to Fly", dated July 31,

2000. This press release announced that first flights would commence on September 5, 2001. Ultimately, this was the date on which CanJet flights commenced, so the "delay" referred to here is puzzling. Further, although Air Canada did match the fares initially announced by CanJet on July 31, 2000, they were higher than the fares actually being charged by CanJet on September 1, 2000 (the day they were introduced by Air Canada). Prior to Air Canada's introduction of the "matching" fare, a price war between CanJet and Royal had led CanJet to reduce its fares from those it had introduced on July 31, 2000.

It is also claimed that Air Canada "had cut its one-way fare on the Ottawa-Halifax route to $99 with no restrictions." In fact, the fare had a 14-day advance purchase restriction, was non refundable, had applicable change fees, was flight specific, and was subject to highly restrictive inventory conditions. As such, by any standard these fares are highly restrictive.

(b) **Frequent Flyer Points**

It has been suggested that Air Canada has used its frequent flyer point program to devious ends. Stanbury and Ross say that: "We were told by a knowledgeable interviewee that Air Canada began offering double and triple Aeroplan points on many flights just at the time RootsAir began selling tickets in anticipation of its start-up on March 26, 2001. It should be remarked that, both Air Canada and Canadian, have in the past, made numerous offers comparable to the Q1 Aeroplan Offer for 2001. Furthermore, the Q1 Aeroplan Offer for 2001 covered, *inter alia*, all domestic routes. To imply, then, that it was instituted in order to hurt RootsAir, who had only announced two routes (Toronto-Vancouver and Toronto-Calgary), is wrong.

The authors also imply that Air Canada is dragging its heels on giving RootsAir access to its Aeroplan points, stating that "… as RootsAir has found out, gaining access to Aeroplan for its customers is more complicated than citing the Undertaking Air Canada gave the Commissioner of Competition on December 21, 1999." This is true, bringing RootsAir online the Aeroplan system is a private transaction between the two parties that involves the exchange of confidential information and requires the parties to settle various issues related to IT issues, customer databases, service fees, payment schedules and other financial issues. It is unquestionably complicated and Air Canada's experience with other airlines shows that it takes a ramp-up period of approximately 90 days to bring a new Aeroplan partner online.[8]

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[8] Furthermore, Roots Air only contacted Air Canada in respect of participation in Aeroplan in early 2001, even though it has been planning its launch for more than one year. At the time that it contacted Air Canada, there were already eight other eligible Canadian Air Carriers (as defined in the Undertaking) who had approached Air

(c) **Business travellers**

At p. 2-7, Stanbury and Ross state that "Air Canada dominates the business traveller product market." Air Canada does not believe that, for competition purposes, there is a separate business traveller product market. Typically, many of Air Canada's customers travel for both business and leisure reasons – *i.e.*, there is no business and leisure traveller, it is simply the same traveller travelling for different reasons. While there may be a small segment of business travellers who are less price-sensitive, a large portion of business travellers are from small and medium-sized businesses and are price-sensitive in a similar way to leisure travellers.

Stanbury and Ross suggest, at p. 2-7, that "business travellers should expect higher fares and possibly a decline in service quality. The latter will likely be manifested in several ways: reduced frequencies compared to what existed under the duopoly with CAC; higher load factors; lower corporate discounts (see below); and possibly reduced amenities in the cabin and/or at airports." Air Canada disagrees with these suggestions:

Air Canada instituted no price increases for business travellers in 2000, in a period while business fares typically increased 8-10% in the United States, and when fuel costs were going through the roof. One fare increase of 6% was instituted in 2001, however this was done across the board -- *i.e.*, not targeted at business travellers. Generally speaking, fare increases by Air Canada for business travellers have lagged behind the international and US markets. Air Canada also introduced new ACFlex fares in January, 2001. These ACFlex fares were specifically aimed at the needs of business travellers and represented savings of up to 50% on all markets across Canada.

With respect to reduction in the total number of frequencies, this was certainly an unavoidable and desirable consequence of the merger with Canadian. With the total combined number of frequencies that were in the marketplace prior to the merger, the result was that one competitor went bankrupt. When the merger occurred, an important part of the post-merger restructuring was to rationalize the combined schedules of the two carriers. It would not have been economically viable to do otherwise. While there may be, strictly speaking, less frequencies flown now than there would have been prior to the merger, this does not represent less choice to the consumer. Removing a Canadian flight that may have departed at 9:05am when there is already an Air Canada flight at 9:00am may result in one less frequency but the consumer's choice of departure times is not affected in any meaningful way. In fact, in many cases, the integration of the schedules has allowed

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Canada before Roots Air with a view to purchasing FFP points and who Air Canada had to reach agreements with.

Air Canada to create additional choice for the consumer by moving departure times that were previously head-to-head to other slots throughout the day, creating more choice.[9]

Air Canada is proud of many recent advancements in services offered by the carrier to business customers and believes that the general level of service quality will have increased since the merger, particularly upon the full integration of technology systems and employee groups. Air Canada continues to roll out automatic check-in kiosks at airports and has introduced additional priority check-in services. Air Canada has also introduced a VIP concierge service for selected passengers. In addition, Air Canada has added additional onboard amenities to many flights including onboard wireless communications and onboard defibrillators. In addition, many new enhancements continue to be developed for future implementation.

4. Other Comments

One general point of clarification: Stanbury and Ross state on more than one occasion that Air Canada has over two-dozen fare classes. This is partly true. Air Canada has the ability to create up to 26 fare classes -- the system used allows Air Canada to create one class for each letter of the alphabet. However, Air Canada's published fare structure only includes 10 fare classes. The other 16 are not published and are used for secondary purposes, typically for Aeroplan redemption, code-share blocks, ski-tour operators and the like.

C. SUGGESTED MEASURES TO INCREASE COMPETITION

1. Liberalization of Entry into Domestic Aviation

(a) Rights of Establishment

Stanbury and Ross recommend that Canada grant rights of establishment to foreign carriers, similar to those granted in Australia, and comment that "[this] would not threaten the existence of efficient Canadian operators in our view… [a]s the Canadian operations will operate much as any Canadian firm the playing field will be relatively level."[10] While it is true that rights of establishment are currently being experimented with in Australia, it would be a serious mistake to assume such an experiment should be allowed in Canada.

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[9] Stanbury and Ross also suggest, at p. 2-13, that "… to the extent that passengers cannot get seats when they want, there is a reduction in the quality of service they have received." Air Canada does not agree that there was any significant reduction in the ability of passengers to get seats post-merger. If passenger load factor ("PLF") from 1999 is compared against 2000, there is only a minor increase in domestic load factor, certainly not large enough to support the argument that people generally are not getting seats.

[10] At p. 5-20.

There are several significant differences between the Australian example and Canada. Australia is geographically isolated while Canada is not. Canada is adjacent to one of the largest, most aggressive and competitive aviation industries in the world. Any carrier operating in Canada and owned by US interests would be closely linked with a US carrier, or fully integrated.

Adopting such a policy, in Air Canada's view, has enormous implications. Canada essentially would have given away the right of cabotage – without reciprocal benefits for Canadian carriers. The cost structure of a US owned carrier is much lower than that of similar Canadian carriers and it is likely this would be perpetuated in Canada. Aircraft servicing would take place, not in Canada, but in the United States. As a consequence, it is also fair to assume investment would take place in the United States – not Canada.

(b) **Cabotage**

Stanbury and Ross, at p. 5-20, state that "granting full rights of cabotage to all foreign carriers would be a very big step to take unilaterally and is not one we would advocate at this time." Air Canada agrees with this statement.

Unilateral cabotage, or permitting foreign owned carriers, particularly US carriers to operate in Canada's domestic market, without fair and reasonable reciprocal terms for Canada's aviation industry, has the potential to devastate Canada's aviation community. The routes flown would be limited to Canada's prime markets; secondary markets would not benefit.

While concepts such as this may be tempting, they have the potential for long reaching negative consequences, particularly for smaller airlines and smaller Canadian communities.

Air Canada would be impacted but the greater strain would be on other Canadian airlines currently establishing themselves on the very routes that would be targeted by foreign carriers.

(c) **Foreign Investment**

Stanbury and Ross note, at p. 4-12, that "[m]oving the foreign ownership limit from 25% to 49% would make it easier for new Canadian carriers to attract foreign capital, and through equity swaps with other airlines, expertise." Air Canada has stated before that it supports changes which would permit increased foreign investment up to 49% of the voting interest in Canadian carriers, so long as effective control remains firmly in Canadian hands.

(d) **Concluding Comments on Liberalization of Entry**

While raising questions about foreign competition, Professor Lazar, in "Potential Market Impacts of Liberalisation Options on the Commercial Canadian Aviation Industry" (Draft), March 8, 2001 pointed out that the small size of Canada's domestic market makes it less inviting than some may assume. Similarly Professor Ken Button and Steve Morrisson at the *Canada Transportation Act* Review Aviation Workshop, Montreal, March 18, 2001, made similar comments, noting that the small size of Canada's domestic market is most likely the biggest barrier to new entry.

Professor Lazar favours exchanging modified sixth freedom rights with the United States and the relaxation of ownership rules as the best way forward. That is, create more competition as opposed to stifling competition through a restrictive regulatory regime. This is consistent with the direction being followed in the rest of the world through, *e.g.*, initiatives by the EU and TCAA.

Air Canada agrees that the best way forward is an approach that encourages vigorous competition in the airline industry rather than suffocating competitors with onerous regulations.

2. Improving the Competition Act

At p. 5-7, Stanbury and Ross discuss the "recent amendments (Bill C-26) to the *Competition Act* which are designed to deal with predatory conduct in the airline industry through the civil law abuse of dominant position provisions." What Stanbury and Ross fail to note is that Bill C-26 did not only affect the abuse of dominance provisions as they relate to the airline industry but also amended many other statutes. Bill C-26 ultimately conferred jurisdiction on two separate administrative bodies – the Competition Bureau and the CTA – which, in Air Canada's view, have been acting inconsistently on several occasions, forcing Air Canada to alternately lower or raise prices depending on their own particular interpretation of the "public interest" in any one situation. This inconsistency and lack of clarity in the rules makes managing the airline very difficult for Air Canada.

3. Asset Sharing

Air Canada notes that along with the aggressive prohibition of alleged potential predatory behaviour, the requirement that Air Canada share various assets, services and facilities with competitors on "normal commercial terms" is a centrepiece of the government's approach to limiting post-merger market power by Air Canada. As is the case with the predatory pricing regime, there is surprisingly little discussion by Stanbury and Ross of either the design or the potential efficacy of

these requirements.[11] What does the term "normal commercial terms" mean? What, if any, are the appropriate terms for licensing an asset that is part of a firm's competitive identity to one or more of its competitors? Where licensing or providing access to competitors may be practical and may even have precedent, there remains the question of the extent to which the access price should reflect the value of lost network business as is the case with the Efficient Components Pricing Rule, which is the most widely used method for determining access pricing.[12] It would be useful, in Air Canada's opinion, for the authors to analyse asset sharing further.

4. <u>Preferred Treatment for Non-Alliance carriers</u>

In "Key Aspects of Global Strategic Alliances and the Impacts on the Future of Air Canada and other Canadian Air Carriers", submitted to the *Canada Transportation Act* Review Panel on March 5, 2001 by Dr. Tae Hoon Oum, the author makes several recommendations at page 34, with regard to enhancing competition on international routes. Although Air Canada's view is that there is no lack of competition on international routes, each of Dr. Oum's recommendations are addressed below:

- *Require Air Canada to offer non-aligned foreign carriers the same interline airfares for domestic destinations/origins that they offer to their Star Alliance partners.*

This is similar to the suggestion made before, but not adopted by, the UK Competition Commission (June 2000). Air Canada has many interline airfares – or, more accurately, interline rates or prorate agreements – that are not part of Star Alliance (*e.g.*, mutually beneficial agreements with Air France and SwissAir). Each such agreement is freely negotiated, and Air Canada is willing to negotiate such agreements with other partners going forward. For example, Air Canada does not currently have such an agreement with British Airways, however, Air Canada and British Airways are in the process of commencing negotiations with the aim of arriving at a mutually beneficially agreement. Furthermore, with Canada 3000, WestJet, RootsAir et al. now in the market, there are also viable alternatives for non-aligned foreign carriers to obtain coverage to major interior points. Air Canada should not be obliged unilaterally and on a non-reciprocal basis to give access to its domestic network without obtaining access to the foreign carrier's domestic network.

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[11]Later in their study, the authors recognize arrangements of this nature are potentially problematic when they state: "That said, relying on a competitor to provide an important element of your service offerings is not something most firms like to do." (p.5-17) They do not discuss the pitfalls of these arrangements any further.

[12] For more on asset pricing, please refer to "Parity Pricing and its Critics: A Necessary Condition for Efficiency in the Provision of Bottleneck Services to Competitors." The Yale Journal on Regulation (Winter 1997), Baumol, Ordover and Willig.

- *Require Air Canada to offer the same airport handling charges to both the Star Alliance members and unaligned foreign carriers.*

Air Canada is not in the handling business, *per se*. Unlike some other carriers who operate separate revenue-producing ground handling business units, Air Canada runs its ground handling business as a necessary adjunct to its own mainline business and nothing more. In fact, Air Canada is known to many in the industry, even its Star Alliance partners, to be a rather expensive source of ground handling services because of our cost structure.

Although some Star Alliance members receive preferential treatment because Air Canada has a reciprocal deal whereby Air Canada is given a cheaper rate for handling in the partner's own country, this is not always the case. Some Star Alliance members choose not to be handled by Air Canada because of the high price which Air Canada must charge to recover its own costs of providing the service.

There are many alternatives to Air Canada for foreign carriers - both Star Alliance members and otherwise. For example, many foreign carriers secure ground handling at T3 at Pearson from other carriers as well as third-party fixed base operators who are able to provide this service (*e.g.*, Hudson General, Ogden Aviation).

- *Devise methods to encourage alliances between non-Star Alliance carriers and small Canadian carriers.*

Air Canada agrees with this suggestion.

5. Divestiture of CRAL

- *It is very important that the government of Canada (or Bureau of Competition Policy) revisit the issue of getting Air Canada to divest the Canadian Regional system[…]*

This issue raised again by Dr. Oum has, of course, already been addressed in that Air Canada offered CRAL for sale to any offeror willing to pay fair market value or better, as determined by an independent arbitrator under the Undertakings. While a number of expressions of interest were received, none of the offers were for fair market value. It would be inappropriate to re-open this issue now.

The potential acquirors recognized that the fundamental purpose of a regional network is to provide feed to the mainline carrier and that alignment with a mainline carrier is integral to the success of a regional carrier in order to provide it with access to a comprehensive network. Without such a commercial link, the prospects for success are minimized.

6. Prohibition of a Discount Carrier

In "Key Aspects of Global Strategic Alliances and the Impacts on the Future of Air Canada and other Canadian Air Carriers", Dr. Oum, at p. 36, also states that:

- *It would be another major mistake if the Government of Canada allows Air Canada to establish a discount air carrier[…]*

The author's antagonism towards the establishment of a discount air carrier is problematic in light of the fact that the author has elsewhere suggested that Air Canada is an unproductive carrier, and that Air Canada is likely to become less productive if not pressured by more competition. Establishing a discount air carrier could be an integral step in the process of making Air Canada more productive and addressing its high cost structure. Many of the world's major carriers already have low cost arms: United, USAir, Delta and KLM, to name a few. This is both a standard practice and an ongoing trend in the global airline industry.

7. Allow Reciprocal Cabotage

At p. 36, Dr. Oum also recommends that:

- *Before the proposed-TCAA (Trans-Atlantic Common Aviation Area) becomes a reality, and before the foreign ownership limitations on airlines are substantially reduced or removed, it is in Canada's advantage to negotiate with U.S. for a single Canada-U.S. aviation market including cabotage. This will enhance opportunity for Air Canada to transform itself as a North American carrier (either by acquisition or expansion into U.S. domestic markets) as CN Rail has been doing successfully since the 1990s.*

Air Canada supports further liberalization of the Canada-US market including reciprocal cabotage. Please see Air Canada's position on cabotage, presented above at paragraph C.1(b).

D. PERFORMANCE OF CANADIAN CARRIERS

1. Historic Performance of Competitors in the Canadian Airline Industry

(a) General

In "Assessment of Recent Performance of Canadian Carriers", submitted to the *Canada Transportation Act* Review Panel on February 13, 2001 by Dr. Tae Hoon Oum and Dr. Chunyan Yu, the authors attempt to assess the performance of Canadian carriers during the 1990s, and to analyze the performance differentials between Air Canada and CAI over time, and between Canadian carriers and the major US carriers. As Dr. Oum and Dr. Yu will no doubt attest, it is very difficult to

collect the necessary data to make such comparisons, and there are important differences in both the methodologies used by different carriers in collecting such data as well as in the carriers themselves (output size, network and output mix). Furthermore, there are significant differences in the environment within which Canadian and US carriers operate, making these kind of comparisons extremely difficult.

We have attempted here to outline some of the problems with the comparisons made but, generally speaking, Air Canada agrees with the comments of Professors Button and Morrison made at the *Canada Transportation Act* Review Aviation Workshop, Montreal, March 18, 2001, wherein they suggested that the data used in the paper was insufficient. Air Canada submits that such data was not adequate to reach the conclusions presented in the paper by Dr. Oum and Dr. Yu. This observation is reinforced by the incongruity of the paper's conclusions; the carriers that are ultimately deemed by the authors to be among the most cost competitive (Canadian, America West, Northwest) are the very carriers who had the greatest financial difficulties.

(b) **Stage Length**

Dr. Oum and Dr. Yu note that: "In general, average stage length [over the 1990-1999 period] has a slight upward trend for most airlines as they expand their network to cover a larger geographical area."[13] In fact, during the 1990s, the major North American carriers outsourced many short haul markets to connectors or regionals, thereby increasing the stage lengths of the mainline carriers. If the regionals were factored in, however, a materially different conclusion might have been drawn.

(c) **Passenger Load Factors ("PLFs")**

In "Assessment of Recent Performance of Canadian Carriers", Dr. Oum performs comparisons of PLFs among North American carriers.[14]

It should be noted that prior to 1996, both Air Canada and Canadian did not count Frequent Flyer Point redemption passengers in their load factors. US carriers, on the other hand, did. This probably affected the PLFs of the Canadian carriers by approximately 4 to 5 percentage points.

(d) **Performance Measures**

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[13] Oum and Yu, p. 4.
[14] Oum and Yu, p. 5

At p. 6, Dr. Oum and Dr. Yu remark that they will present both the gross measures of airline performance and the residual performance measures after removing the differences in output size, output mix and network. Performing this analysis accurately, however, would require that Canada's regulatory and infrastructure cost base be the same as the United States, which it is not. In Canada, domestic fuel taxes are higher and airport navigation fees are historically higher. In addition, international user charges are much higher than domestic user charges.

(e) **Labour Input Prices and Labour Cost Shares**

At p. 9, Dr. Oum and Dr. Yu note that a sharp decline in Air Canada's labour cost share was attributed to the depreciation of the Canadian dollar and to the reduction of its workforce. This was also due to US expansion where Air Canada subcontracted its labour requirements to Continental and then UAL, wherein terminal charges were incurred as opposed to staffing charges.

(f) **Fuel Input Prices and Cost Shares**

The substantial gap between fuel prices paid by Air Canada and Canadian and those by the US carriers, identified by the authors, can be largely explained by higher domestic fuel taxes in Canada.

(g) **Lease Rates**

At p. 11, the authors note that, as the same lease rates have been applied to all airlines, differences in aircraft capital prices reflect differences in fleet composition. Air Canada believes that this is not entirely true, as there are some differences due to credit worthiness/risk of the carrier.

(h) **Capital Input Prices and Cost Shares**

At p. 12, the authors state that "Air Canada's capital cost share has been increasing… reflecting Air Canada's increased investment in its fleet." While fleet expansion is one reason for this increase, other capital investments required due to fleet renewal, new noise regulations and the desire to trade higher capital costs for lower operating costs (through more efficient aircraft) also contributed to increased capital costs.

(i) **Materials Input Price**

At p. 15 the authors state that Air Canada and CAI enjoyed lower materials input prices than the US carriers. Air Canada disagrees with this statement. Most materials (spare parts, *etc.*) are US dollar based commodities.

(j) **Fleet Quantity Index**

At p. 18 the authors state that: "For flight equipment, a fleet quantity index is constructed by deflating total annualized aircraft cost by the aircraft price index discussed in Section 3.3. Air Canada does not understand the methodology used here and questions its validity.

(k) **Labour Productivity**

It is not clear, in the analysis at p. 20, whether the authors have netted labour costs to account for the labour component in other revenue.

(l) **Fuel Productivity**

At p. 21 the authors note that CAI had the highest fuel productivity for most of the decade. This is due to excise tax rebates and the fact that a higher portion of fuel costs were on international flights, thus not attracting domestic fuel taxes.

(m) **Capital Productivity**

The methodology used here is suspect. Using the methodology suggested by the authors for calculating capital input productivity it seems clear that old or ageing fleets would be considered more productive and score higher than younger fleets. Northwest and Canadian, both of whom are highlighted as top performers, avoided fleet renewal during this time period, which likely contributed to problems in other areas and certainly precluded both carriers from taking advantage of productivity gains from new capital.

E. AIRPORTS AND AIRPORT AUTHORITIES

1. General Comments

In "Airport Financing, Costing, Pricing and Performance", Professors D. Gillen, L. Henriksson and W. Morrison examine the activities of airport investment, service delivery, pricing and financing under the 1995 *National Airports Policy*. The stated goal of the research was to provide the Review Panel with an assessment of how well the airport programs (and the airports operating within them) are meeting the needs of Canada and Canadians. In light of this, it is unfortunate that the authors chose to interview only the managers and senior executives at the airports themselves and did not speak with other stakeholders, including the airlines.

By not speaking to all stakeholders, the authors may have unintentionally received a biased viewpoint on some of the issues, as the local airport authorities often have their own particular agendas. As a result, the paper often seems to have a black or white outlook and, all too often, Air Canada is portrayed in an unflattering light. A more balanced perspective would have given some recognition

to the importance of Air Canada in establishing a strong Canadian airline industry in what is fast becoming a global marketplace.

As a general comment, in both the paper by Gillen, Henriksson and Morrison and in "Airport Ownership, Management and Price Regulation" (Draft),[15] by M. Tretheway, the authors make several recommendations which seem aimed at punishing Air Canada for being the largest carrier in Canada without regard for the crippling effect the recommendations would have on Air Canada's ability to compete with US based carriers. This issue of competition with US based carriers will be addressed later but first, Air Canada's comments on some of the issues raised, and changes recommended by these papers, are presented below.

2. Issues and Paper Recommendations

(a) Charge-per-passenger Ground Lease

Gillen, Henriksson and Morrison recommend that current ground lease arrangements be renegotiated solely on a charge-per-passenger basis. Air Canada agrees that the ground lease arrangements do need to be changed from the current arrangements as currently there is no limit on ground rents and the quantum of rents is not, typically, tied to any objective or valid measure. These payments are effectively passed through to the carriers as a further component of rates and charges assessed against them and it is not apparent that the scope and quantum of such payments are reflected in the provision of services either to the airports or to the carriers and their customers. In fact, some services previously provided by the Government are now supplied by local airport authorities and charged directly to the carriers.

As is reflected at Note 10 at p. 14 of the Tretheway paper, IATA, ICAO and ACI all have airport pricing principles which embrace the concept of cost based aeronautical charges. To the extent that ground leases are effectively passed through to the carriers as a component of rates and charges assessed against them, it is clear that neither the current ground lease system nor the charge-per-passenger ground lease system would be true to the principle of cost based aeronautical charges.

Air Canada recommends that ground rents be based on the unamortized portion of government investment at airports prior to privatization (and thus decrease over time). This would help ensure that the airport system is not simply viewed as a "cash cow", as has perhaps been the case in the past, but rather as an economic tool for strengthening the country's economy.

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[15] Report prepared for the Canada Transportation Act Review Panel, March 14, 2001, M. Tretheway

(b) Monopolistic behaviour of airport authorities

Gillen, Henriksson and Morrison state that airports are not monopolies. Air Canada disagrees strongly with this statement.[16] Most of Canada's major airports have very little real competition. They comprise in a real sense monopolies in their own right and are exercising extensive authority and control over the activities of airlines in their domain. Such authority has in large measure been exercised without a clear regulatory framework to achieve greater transparency and accountability. For example, it is interesting to note that the air carrier community which itself, through rates and charges, provides the vast preponderance of revenue to local airport authorities has no statutory or contractual role in the application of such revenues in either the operating or capital budgets of the authorities.

Tretheway states, at p. 25, that: "Airlines have significant countervail powers vis a vis airports." Air Canada strongly disagrees with this statement. Perhaps the best example is the situation at Pearson Airport where Air Canada had to resort to litigation in an effort to reduce in scope a $4.3B capital improvement project (Air Canada was of the belief that a much more cost-effective project could be completed).

The experience at Pearson is relevant to another problematic issue for airlines. When airports were under the governance of the Federal government, there was an opportunity to examine the number and size of airport capital improvements that were scheduled at any one time and consider the "big picture" in terms of the impact on Canada and its aviation industry. Now that the airports are privatized, each is only considering its own wants and no-one is left to assess the overall impact. Currently, capital programs at airports are being paid, in large part, by Air Canada and indirectly, by Air Canada's passengers. The costs for these programs (including the $4.3B program at Pearson) will be felt all at once and will subject Air Canada to not insignificant risk. Air Canada strongly recommends the institution of proper consultation procedures on capital improvements of the kind that are being introduced by the FAA in the United States.

Tretheway also claims, at p. 47, that airlines have "delaying powers via the AIF collection agreements that many airports have entered into with their arline customers." This power is greatly overstated, being really nothing more than the power that any person has to withhold monies owed under a legal contract – like threatening not to pay your plumber, if you will.

[16] For certain stakeholders this may be true – for example, connecting passengers who may choose one connecting hub over another. For the airlines, however, the airports are monopolists -- an airline cannot simply just divert their business to another hub.

At p. 25, Tretheway notes that: "In fact, the countervail power of the air carriers is so strong that when Air Canada and Canadian merged, the Competition Bureau required that the AIF veto powers be reduced so as to prevent a single carrier from controlling airport capital decisions." Air Canada believes that a conclusion has been drawn here out of context. As part of the merger with Canadian, Air Canada was requested to review voting procedures, which it did. Air Canada voluntarily agreed to reduce its voting powers which, on a per passenger basis, would have put other carriers at a disadvantage. *Vis-a-vis* the airports however, Air Canada has very little countervail power with respect to airport capital decisions as the situation at Pearson has amply demonstrated.

As many of the airports act in a monopolistic environment, transparency, accountability and consultation principles must guide the relationship between the airlines and the local airport authorities. Air Canada is anxious to achieve a much greater level of open co-operation with local airport authorities. As noted by Tretheway at p. 31, there is currently no requirement for federal, provincial or user representation on the Board of Directors of the local airport authorities. Air Canada recommends user representation to help improve communication and relations between airports and users and to help move towards these goals of transparency, accountability and consultation.

(c) **Airport improvement fees**

On the revenue side, Gillen, Henriksson and Morrison address the issue of airport improvement fees. However, they did not look at the United States model where the airport is allowed to collect for airport infrastructure and has a maximum charge of $4.50USD per airport and a maximum of 4 airports per ticket for a maximum total of $18USD. In Canada, there is no maximum restriction and so consumers could conceivably, on a multi-leg flight be charged up to approximately $100CDN on a ticket. More stringent controls are required on the amount that airports are allowed to charge passengers for airport improvements. More meaningful consultation between airports and carriers with regard to airport improvement projects and AIF programs also takes place in the United States where most airline leases have a provision requiring the airport to consult the signatory airlines before the implementation of a project. Too often, in Canada, airports will commence airport improvement projects and AIF programs without consulting with the carriers beforehand.

(d) **Gates**

Gillen, Henriksson and Morrison suggest that all gates should be owned and allocated by the airport and that Air Canada be required to sell the gates it owns back to the airports. This suggestion that Air Canada should no longer have control of the facilities it uses is frightening.

Air Canada runs a sophisticated three-level operation (domestic/transborder/international) that necessarily entails an intricate schedule and timing process to allow all three of these categories of passengers to make the necessary connections. Control of facilities is integral to the proper functioning of this process. Thus, we see that in every other country, the major carriers -- those who also operate three-level operations – have control over their own facilities.[17] In the United States, all of the major airlines and all of Air Canada's primary transborder competitors own their own gates.[18]

Of course, should there be another carrier in Canada with this kind of operation (level and type) then they too will need this kind of control over facilities.

Air Canada committed in the Undertakings to make facilities, including counters and gates, available at certain airports to ensure other carriers had a reasonable and fair basis upon which to compete. Air Canada has lived up to these commitments.

(e) **Peak-demand slot pricing strategy**

Gillen, Henriksson and Morrison recommend that a portion of Air Canada's domestic slots at Lester B. Pearson International Airport for peak-demand periods should be surrendered to a pool to be auctioned to the highest bidder.

This suggestion assumes that airports in Canada are to be run as businesses, attempting to profit from the activities of the carriers, in whatever way they can. Air Canada submits that this should not be the case. Airports should act as support to the airline industry. Airports in the United States have examined this suggestion of peak-demand slot pricing but, to Air Canada's knowledge, none has opted to institute such a policy.

The implementation of such a scheme would only mean the addition of another level of bureaucracy and the costs of bidding on these slots would ultimately be passed on to the consumer in the form of higher fares. At peak times, carriers such as Air Canada are trying to connect hub passengers. These peak-time passengers, potentially faced with the higher fares that Air Canada or another domestic carrier would be pressured to charge in order to cover the cost of this peak-demand slot pricing, would seek out lower-priced options elsewhere – *i.e.*, by

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[17] *E.g.*, Air France, Lufthansa, British Airways, United, American, *etc.*

[18] In fact, as is indicated at para. 2.7 of "Airport Ownership, Management and Price Regulation", prepared for the Canada Transportation Act Review Panel by M. Tretheway, some US and international carriers develop their own terminals – *e.g.*, United Airlines' terminal at Chicago, and the various airlines' terminals at New York's JFK. Tretheway also notes that in Australia, the two major carriers (Ansett and Qantas) own and operate their own domestic terminals at all major airports.

travelling through hubs (*e.g.*, in the United States) that do not have peak-time slot pricing.

With regard to slots, access is not really an issue in any airport in Canada, with the possible exception of Toronto, and even there, only the daily peak evening period. Here again, the problem has not been very pronounced, and slots have been found in this time period, even during the past summer.

(f) **Airside Charges**

Gillen, Henriksson and Morrison recommend, at paragraph 4 of their executive summary, that airports should move to passenger-based airside charges. Air Canada disagrees with this recommendation. Air Canada does believe that airports should break even and is willing to contribute its share to assure that this does happen. However, moving to passenger-based airside charges only makes it more difficult for Canadian carriers, including Air Canada, to achieve economies of scale. Without this ability, competing with US carriers who are not restricted from achieving these economies would become even more difficult. Air Canada believes that efforts should be made to improve the situation in Canada and make it easier to compete, not make it worse.

(g) **Relations with Air Canada**

At the second point at p. 164, Gillen, Henriksson and Morrison comment, apparently based on a conversation with an airport authority, that Air Canada was to surrender one gate (that belonged to CAI), but Air Canada decided to keep the gate and only “surrender” it to common use. The authors do not disclose precisely what this was related to but Air Canada notes that it has lived up to its obligations under the Undertakings given to the Competition Bureau.

At the seventh point at p. 164, Gillen, Henriksson and Morrison present another allegation from an unidentified source that “Air Canada certainly exerts undue influence in the control of gates.” It is not clear what is meant by this or on what basis such an allegation is made.

(h) **Common Trends**

At page 38, Tretheway identifies some common trends emerging from a survey of quasi non-government organisations:

- Governments, especially the Federal Government, are being given greater powers to nominate directors to Boards than was the case of the original LAA policy.

- Formal public notification processes are now stipulated prior to making changes to fees.
- Formal appeal mechanisms are provided to resolve disputes between the authorities and their stakeholders.
- More stringent audit requirements are being placed on authorities.
- Some restrictions are being placed on the ability of authorities to create subsidiaries and undertake ancillary activities.

Air Canada believes these trends are positive.

(i) **Further issues to address**

Neither paper on airports addressed some key issues related to the operation of airports and the relationship between airports and airlines. One issue in particular that the authors did not address, but may wish to consider is that, currently, fuel taxes go back into general revenue coffers. Perhaps these revenues would more appropriately be earmarked for airport improvements or to help fund smaller airports, but in any case stay within the industry. The US Government directs a portion of ticket taxes in this way, re-investing these revenues in the US airline industry through grants.

3. <u>Canadian Carriers' Ability to Compete</u>

As mentioned earlier, many of the recommendations made in the two papers on airports (*e.g.*, removing control of gates, charge-per-passenger ground rents and other charges, peak-pricing slot allocation) would have a serious negative impact on Air Canada's ability to compete with international carriers, in particular US carriers.

Whether the government approves of the approach in the United States or not, the fact is that this is the environment in which US carriers operate. In the United States, the major carriers have exclusive leases for required facilities. The major US airports have rates and charges methodologies which permit US carriers to attain economies of scale. The regulatory structure in the United States permits airlines to control their facilities, operations and their schedule and to keep costs down as they grow. Many of the recommendations would remove the ability of Air Canada and other Canadian Carriers to have control of facilities comparable to their US competitors. Adopting these recommendations will not result in a fair competitive environment as between the carriers of the two countries.

At page 6, Tretheway lists three major policies put into place in the United States to help the aviation industry:[19]

- U.S. airports have utilised bond guarantees from the airlines using their airports in order to obtain low interest rates and the ability to obtain higher debt:equity ratios than would otherwise be possible…
- U.S. airports qualify for municipal status and can issue bonds which are free from income taxes…
- The U.S. federal government has established a tax on airline tickets whose proceeds are used to provide capital grants to airports…

In Canada, policies must also be put into place to help promote the growth of the Canadian airline industry and to ensure that Canadian carriers can compete effectively with the US carriers. This is particularly true in the context of the Open Skies policy and also if we are to seriously consider reciprocal cabotage. How can Canada not do everything it can to ensure that all of its carriers – not just Air Canada—have a level playing field?

F. CONCLUSION

Much of the Canadian air transport regulatory framework can be viewed in the larger context of deregulation in Canada and the lessening role of government in the economy. Starting from a position of strict regulation in the 1960's, the forces of the free market and competition have increasingly replaced government edicts and directives.

However, the recent changes in the Canadian airline industry have ushered in a new set of policy and regulatory issues and concerns. The Canadian regulatory framework must continue to evolve to ensure that all stakeholders are well served in this new environment.

In considering how this regulatory framework should evolve, the Government should be mindful that intrusive restraints on air carriers may in fact prevent the lowering of prices and increases in output. This would obviously be contrary to the primary purpose of competition laws, which is to benefit consumers. Therefore, it is important that anti-trust regulators are extremely careful not to discourage price reductions or increases in output except in situations where it is clear that consumers will ultimately be harmed.

The Government must also be extremely careful that it does not enact regulations which will have a chilling effect on Air Canada's ability to compete in

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[19] Note that Tretheway takes issues with these policies.

the marketplace, to the detriment of the consumers of air travel. Air Canada cannot be expected to sit by without responding to new entry and increased competition. Indeed, consumers and the public would not be well served if Air Canada were it to ignore competition in the marketplace by refusing to respond to competitive pressures.

Air Canada continues to believe strongly that its conduct and behaviour is consistent with our recognition of our responsibility to the travelling public across Canada. Air Canada recognizes that its position in the Canadian market entails responsibilities. It is our wholehearted intention to meet these responsibilities.