



Competition Bureau
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SPEAKING NOTES

for

**Sheridan Scott
Commissioner of Competition**

COMPETITION BUREAU

Air Liberalization and the Canadian Airports System

Remarks to the House of Commons Standing Committee on Transport

May 4, 2005

(Check against delivery)

Let me begin by thanking the Committee for inviting us here today.

I am accompanied by David McAllister - Major Case Director in our Mergers Branch. Dave has extensive experience in dealing with Bureau-related airline matters.

We applaud your initiative in conducting these hearings and welcome this opportunity to provide a Competition Bureau perspective on the important issue of air liberalization.

For many years, the Bureau has been a staunch advocate of allowing competition and market forces to play a greater role in Canada's airline industry.

For example, we strongly supported the government's 'Freedom to Move' initiative in the mid 1980's on deregulating the domestic airline market.

Our October 1999 letter of advice to the Minister of Transport, on airline restructuring, stated our view that policies on foreign ownership and cabotage - that is allowing foreign airlines to fly domestic routes - were the largest regulatory barriers to entry in the industry and should be reconsidered by the government.

We continue to hold these views today and that is why we believe your hearings are so important.

My remarks will focus on three main areas:

- First, some background on the Bureau's role in the airline sector;

- Second, our view of the state of competition in the industry since the merger of Air Canada and Canadian Airlines in 2000; and
- Finally, our response to the questions raised in the Minister of Transport's 2004 reference paper on airline market liberalization.

Role of the Bureau

As Commissioner of Competition and head of the Competition Bureau, I am responsible for the administration and enforcement of *Competition Act* in all sectors of the Canadian economy, including the airline sector. The Bureau also plays an advocacy role as the champion of competition in Canadian markets.

One of our main roles is to review mergers. In 1999-2000 the Bureau was heavily involved in the review of Air Canada's acquisition of Canadian Airlines. The conclusion was that Canadian Airlines was likely to fail and it appeared inevitable that Air Canada would emerge as the dominate carrier in the Canadian airline market. The Bureau was responsible for negotiating a series of enforceable undertakings with Air Canada to address competition concerns arising primarily in the domestic market.

These undertakings were aimed at reducing barriers to entry and fostering competition in the domestic market. They included, among other things, requirements that Air Canada give up slots at Pearson Airport and surrender facilities at capacity constrained airports, provide access to Aeroplan, interlining and joint fare agreements to eligible Canadian carriers and to defer commencing its own discount carrier service in Eastern Canada for a specified period of time.

In August 2004, the Minister of Transport, pursuant to section 56 of the *Canada Transportation Act*, and after having consulted with the Bureau, agreed to rescind these undertakings on the grounds that they were no longer necessary or appropriate given changes that had taken place in the industry.

Since the merger, the Bureau has also been active in enforcing airline specific provisions that were introduced into the *Competition Act* to address concerns about potential abuse by Air Canada of its dominant market position. This enforcement activity included a number of investigations and litigation before the Competition Tribunal involving allegations of predatory pricing against Air Canada. That litigation resulted in the Tribunal accepting the Bureau's approach to applying a cost revenue test for assessing predatory conduct in the airline industry.

In light of the changes that had occurred in the industry since the filing of the Bureau's application to the Tribunal and the important jurisprudence established in the 1st phase of the case, we concluded in 2004 that it was not in the public interest to proceed with further litigation.

Last year, we undertook a review of the state of competition in the industry and concluded that the special provisions of the *Competition Act* relating to airlines could be repealed, provided that the general abuse of dominance provisions of the Act were strengthened to provide for administrative monetary penalties. Bill C-19 is currently before the Industry Committee. This proposed legislation would repeal the airline provisions, but it also includes a number of other measures to improve the effectiveness of the Act, including administrative monetary penalties for abuse of dominance. I would note that Bill C-19 is consistent with a recommendation from the Industry Committee's 2002 report that the airline provisions be repealed subject to other general amendments to the Act.

In September 2004 we issued a open to the airline industry setting out our enforcement policy. In light of the jurisprudence established by the Competition Tribunal in the Air Canada case, this policy clarified the types of conduct by a dominant carrier that could trigger enforcement action by the Bureau.

Enforcement in the sector remains a priority for the Bureau. We investigate all complaints where there is factual evidence of anti-competitive conduct.

Competition in the Canadian Airline Sector

I would now like to provide a brief overview of how the Bureau views the state of competition in the industry as it has evolved since the time of the merger.

At the outset, however, it should be noted that many of the changes that have overtaken the industry in recent years have not been unique to Canada. Traditional network or “legacy carriers” are being forced to restructure their operations to compete as consumers shift toward services offered by low-cost carriers. Consolidation has occurred and indeed several established players such as Pan Am and Ansett in Australia, to mention two, have disappeared. The growth of the Internet as a means of distribution has also changed the way the airline business operates.

Domestic service competition

The acquisition of Canadian Airlines by Air Canada in 2000 dramatically reduced the level of competition in Canada’s domestic airline markets. The merger resulted in a single competitor having a revenue market share in excess of 90% and eliminated competition that had previously existed between Air Canada and Canadian on the largest 200 domestic city pair routes.

In the five years since the merger, the competitive landscape has changed considerably. Air Canada has emerged from a major restructuring under bankruptcy protection. Important entry by low-cost carriers has occurred with WestJet emerging a strong national competitor. There has also been exit from the industry. As well, the industry has also gone through major shocks caused by events such as

9/11 and SARS.

According to data reviewed by the Bureau, total seat capacity in 2004 for major Canadian air carriers is about 14% below the level that existed at the time of the merger. The main cause of this decline has been a major reduction in Air Canada's seat capacity by almost the same amount as the capacity previously provided by Canadian. While they have been expanding their presence in the market, carriers such as WestJet and CanJet have not replaced all of this capacity.

Air Canada's market share has dropped from approximately 75% in 2000 to 55% based on available seat capacity. Its market share based on revenue also declined from 90% at the time of the merger, but continues to be high, in excess of 70% in 2003, the last year for which this measure has been possible to calculate.

During the same period, WestJet's share of the market has continuously increased. The company's estimated revenue shares increased from under 5% in 1999 to just over 20% by 2003. Combined, Air Canada and WestJet accounted for over 85% of all domestic traffic in 2004. Smaller carriers have moved onto some, but not all, of the routes no longer served by Air Canada. Generally speaking, pricing within the domestic market has been more competitive, particularly on major routes, with greater availability of discounted tickets with fewer travel and purchase restrictions.

Transborder Competition

Air Canada's acquisition of Canadian had more limited competitive implications for transborder air travel due to the 1995 air agreement between Canada and the US which removed most of the restrictions against either Canadian or US carriers serving transborder routes. However, the 1995 agreement, was and continues to limit competition in important respects. For example, 5th freedoms (sometimes referred to as 'beyond rights' - enabling an airline to carry passengers to one country, and

then fly to another country, rather than back to their own) are generally not permitted, 6th freedom services (the ability to carry traffic between two other country via the carriers own country) are restricted and cargo extension services or co-terminalization (the ability to carry cargo to multiple points in a foreign country using the same aircraft) is not allowed.

International Competition

With respect to international services, the acquisition of Canadian by Air Canada eliminated competition that existed between the carriers on the limited number of important routes that they both served. This competition has not been replaced. However, the principal barrier to competition on international routes was and continues to be Canada's bilateral air agreements with other countries. While these agreements provide for some competition on routes between Canada and other countries, they also restrict the specific routes served, the number of carriers on those routes and the frequency of flights.

In summary, the state of competition in the domestic market has improved since the time of the merger. However, in our view there is clearly room for further improvement, not only within the domestic market, but also in regard to transborder and international services.

Bureau Views on the Minister of Transport's Reference Questions

The questions and positions outlined in the Minister's reference paper are all directed toward allowing for increased foreign participation in the Canadian airline industry and providing Canadian carriers with expanded opportunities to serve transborder or international markets through a process of negotiating more open bilateral or multilateral air agreements. On competition grounds, the Bureau strongly supports such initiatives.

Domestic

The Bureau continues to support the eventual removal of all restrictions on the ownership and control of Canadian air carriers. With very limited exceptions, most other sectors of the Canadian economy are not encumbered with ownership controls. There does not appear to be any compelling economic reason why the air transportation sector should continue to have such restrictions.

We recognize that the elimination of all ownership restrictions may not be feasible under current bilateral air agreements. Accordingly, as a first step, the Bureau supports increasing the limit on foreign ownership of voting shares in Canadian air carriers from the current 25 percent to 49 percent. The airline industry is capital-intensive. New entrants, as well as established players, would benefit from greater access to foreign capital that liberalized ownership rules would facilitate.

The Bureau reiterates its support for allowing rights of establishment, to permit foreign owned 'Canada only carriers'. Rights of establishment would allow foreign carriers to draw upon their knowledge and expertise to establish new operations in Canada. A potential benefit of allowing rights of establishment could be an increase in the number of routes served by allowing foreign carriers seeking to develop feed traffic beyond the major gateways.

The Bureau also supports reciprocal cabotage. Permitting foreign air carriers to provide services between points in Canada has the potential to further promote competition on routes within Canada.

The Bureau recognizes that there is an important policy question of whether rights of establishment or cabotage should be granted only on a reciprocal basis. Strictly on competition grounds, a strong case could be made to implement such measures unilaterally. However, air policy involves a broader set of public policy objectives and, on that basis, it would be preferable to negotiate reciprocal rights of establishment and cabotage. However, if this is not feasible within a reasonable period of time, Canada should at a minimum consider following the lead of Australia and unilaterally allow right of establishment.

Transborder

There is no doubt that the current air services agreement between Canada and the US has resulted in important benefits for Canadian consumers and businesses. It has led to substantial growth in transborder services. Canada's tourism industry has benefited, trade has been facilitated and shippers and travellers have greater choice and lower cost. Canadian air carriers have benefited as well, with Air Canada continuing as the largest transborder air carrier. WestJet recently commenced service into the US becoming the first low cost carrier to offer transborder services.

The Bureau supports negotiations to further liberalize Canada's air agreement with the US as a way to further improve transborder service. In our view, the ultimate goal of such negotiations should be the establishment of a single aviation market with the US similar to that which exists within Europe. In short, the case for free trade in airline services within North America is no different than for other sectors of the economy.

At a minimum, negotiations should seek to establish a 'US style' open skies agreement. This would result in reciprocal granting of 5th freedom traffic rights, the removal of all pricing and other restrictions on 6th freedom carrier service and the mutual granting of cargo co-terminalization and 7th freedom

cargo traffic rights (allowing a carrier to transport cargo from the other country to or from a third country even if the flight does not touch down in its home country).

The establishment of 5th freedom rights would benefit Canadian travelers by providing Canadian and US airlines with greater freedom and flexibility in setting up their route networks to third countries. Modified sixth freedom rights would potentially afford consumers more travel options by allowing carriers to serve city markets indirectly through their own domestic hubs.

With respect to cargo, co-terminalization would allow US or Canadian carriers to deliver US or Canadian cargo to the other country using routes having more than one destination in the country of destination. While this would not have the potential competition and efficiency benefits of cabotage, it could provide significant benefits to Canadian businesses and consumers in terms of both costs and time (due to reduced ground handling).

Cargo 7th freedom traffic rights would allow a Canadian cargo carrier to operate cargo flights from the US to other nations, and would allow US cargo carriers to operate flights from Canada to other nations. Since cargo moves uni-directionally and suffers from unbalanced traffic flows, 7th freedom services can be an important element in air cargo economics. This would provide carriers with greater flexibility in designing lower cost, more efficient routes, ultimately to the benefits of Canadian consumers and businesses.

International

The Bureau believes that opportunities for negotiation of international agreements creating more open competition should be pursued on a priority basis and be subject to the minimum number of restrictions possible. With respect to international travel, as is currently the case with domestic air travel, there

should be no distinction between the granting authority for charter versus scheduled service. Rather, it should be left to market forces and the demands and preferences of air service users to determine which type of service or combinations of services should be provided.

Regardless of whether passenger or cargo services are involved, bilateral or multilateral air negotiations should serve, first and foremost, the interests of passengers and businesses relying on aviation services.

However, the Bureau also recognizes the importance of Canadian carriers having fair and equal opportunities to provide service. If the Government were to pursue a policy of liberal open access bilaterals, granting both Canadian and foreign carriers access to serve any city in Canada to any city in the foreign nation this would serve to balance the interest of consumers and carriers.

Conclusion

In summary, the Bureau strongly supports efforts to further liberalize regulation of the airline sector in a manner that would expand the role of competition and the benefits that will flow from such competition to consumers and air transport dependant industries. Given what we have seen occurring in the EU and markets like Australia and New Zealand, a clear trend toward greater reliance on competition and market forces in the provision of airline services is emerging worldwide.

We hope that the Committee will recognize in its report the benefits of competition and the importance to Canada of moving forward with a process to modernize and open up our regulatory regime.

Thank you for the opportunity to share our views with you. We look forward to your questions.