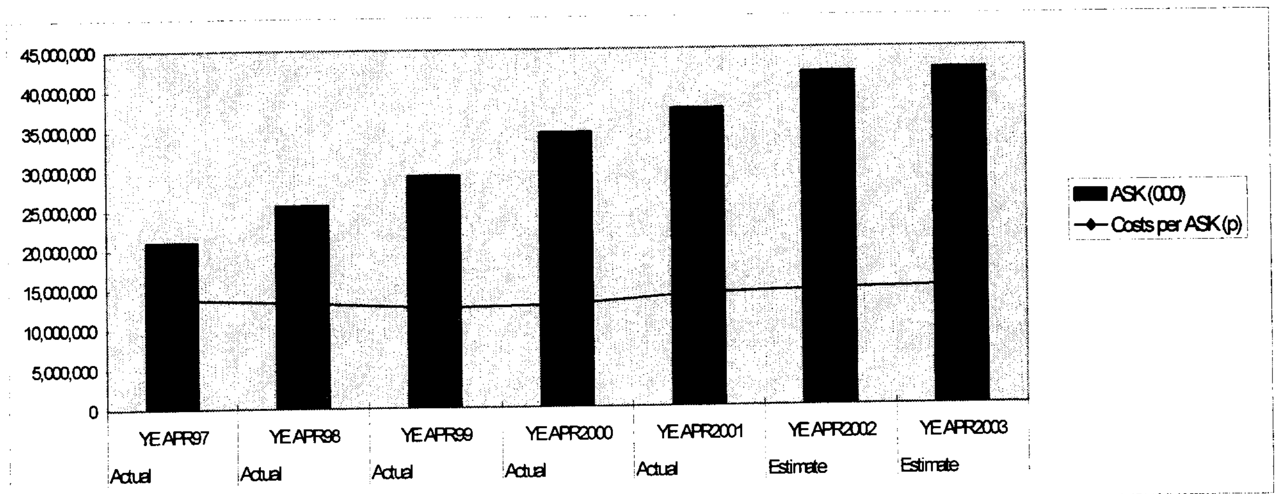
Public benefits

It is difficult to see how there are any substantial public benefits arising from the RJSA, for two reasons. First, it is extremely unlikely that there are substantial cost-savings associated with the RJSA. Second, the RJSA reduces competition and affords Qantas/British Airways substantial market power in the relevant markets.

No returns to scale

Studies have shown that there are approximately constant returns to scale in the provision of air transport services[35], and hence that there are no reductions in per unit costs associated with 'getting bigger'. Figure 1 below shows that this is certainly true for Virgin Atlantic: Virgin Atlantic's unit costs continue to be the same as they were in 1997, despite output (measured here as Available Seat Kilometres (ASKs)) increasing by more than 175% over this time.

Figure 1:
No returns to scale



[35] Caves, D, L Christensen and M Tretheway (1984), "Economies of Density Versus Economies of Scale: Why Trunk and Local Service Airline Costs Differ", *Rand Journal of Economics*, 15(4), Winter; 471-489.

No reductions in overheads

Given that both Qantas' and British Airways' managements have been retained, it is difficult to see how the RJSA has reduced overhead costs. Indeed, these costs are likely to have increased, given that presumably some sort of management team is needed to oversee the RJSA.

Reduced competition

It is also difficult to see how the RJSA has produced the other benefits claimed by Qantas and British Airways, such as lower fares, "higher levels of consumer support" and an increase in tourism, given that it reduces competition in the relevant markets. Indeed, contrary to its claims in this application, British Airways stated in the paper it sent to the Canadian authorities in connection with the acquisition of Canadian Airlines by Air Canada:

> "Competition is always the best solution to ensure consumers receive competitive prices, good service and product choices."[36]

In addition, over the three years the RJSA has been in effect, Qantas and British Airways have not commenced operations in a single new market between London and Australia or London and South East Asia. Indeed, the number of markets they serve between London and Australia has decreased, as British Airways stopped providing services between London and Perth in July 2000 and between London and Brisbane in November 2000.

[36] British Airways, *Competition in the Canadian Airline Industry: Bill C-26*, Summer 2000.

It is probably true that Qantas and British Airways have used the slots and aircraft formerly employed to compete with each other to provide more frequent service in these markets (markets in which they used to compete with each other). However, as stated above, providing more frequent service will more than proportionately increase their market power vis-à-vis competitors given the existence of the S-curve effect and the importance of time-sensitive passengers to service viability in the types of markets in which Qantas/British Airways and Virgin Atlantic operate.

Given that not re-authorising the RJSA will increase competition and hence lower prices, increase output and improve service quality in the relevant markets, it is difficult to see how not re-authorising the RJSA would lead to a reduction in foreign nationals carried by Qantas and a loss of export earnings for Australia, as claimed by the applicants. On the contrary, greater competition will increase the number of foreign nationals carried by all carriers, including Qantas, and increase export earnings for Australia, as foreign nationals spend money there. It is therefore difficult to see why not re-authorising the RJSA would also lead to a net loss of jobs by Australians.

It is also difficult to see how the RJSA has a positive effect on Qantas' international competitiveness. Virgin Atlantic cannot think of a single example where protecting an airline (i.e. "picking winners") has enhanced that carrier's competitiveness. Airlines facing effective competition in the markets in which they operate are continually forced to minimise their costs, reduce their prices and improve the quality of the services that they provide. It is evident throughout the world that the most successful airlines are those that have not been protected by their governments.

It would thus seem to Virgin Atlantic that the best way to ensure that Qantas' and British Airways' international competitiveness improve is to subject them to the discipline of competition, including from each other.

Conclusion

Based on the analysis above, Virgin Atlantic believes that the RJSA raises serious competition and public interest concerns. If the ACCC nevertheless decides to re-authorise it, it must impose severe conditions in order to re-establish effective competition in the relevant markets.

It is difficult to specify such conditions in detail in advance of an understanding of the competitive analysis which might lead the ACCC to grant re-authorisation. Virgin Atlantic would welcome the opportunity to comment further if necessary, following publication of the ACCC's initial findings. However, it is possible to provide general guidance on the conditions which might be applied.

- Airport access: Qantas and British Airways must make available a sufficient number of slots at London's Heathrow Airport, Sydney's Kingsford Smith Airport, Melbourne (Tullamarine) Airport, Brisbane Airport and Perth Airport, together with related facilities such as terminal space, check-in desks, gates, aircraft parking areas, etc., to ensure that competitors are able to provide the level of service necessary to re-establish effective competition. Such facilities, including slots at competitive timings, must be fully available for all potential competitors before re-authorisation is granted.

- Frequent Flyer Programmes (FFPs): Qantas and British Airways must grant full access to their FFPs to any competitor seeking such access, on terms no less favourable than those applicable to any other participant, including Qantas and British Airways.

- Interlining: Qantas and British Airways must make available to competitor airlines interline fares at their hub airports at rates no less favourable than those they charge each other.

- Computer Reservation Systems: Qantas and British Airways must agree not to bias CRS screen displays, including by screen padding (displaying their connecting services more than once).

- Travel Agent and Corporate Deals: Qantas and British Airways should agree not to abuse the dominant position they have in the relevant markets by entering into arrangements with travel agents or corporations whereby sales are in any way "tied".

Virgin Atlantic would also expect that re-authorisation would be granted only for a limited period, after which time the RJSA would be reviewed by the ACCC. A review should also be carried out if co-operation between Qantas, British Airways and Cathay Pacific increases.

Several of the conditions reflect remedies which British Airways itself argued should be applied when Air Canada sought to acquire Canadian Airlines.

Indeed, given the impact on British Airways' operations in London – Canada markets:

> "British Airways' market share is expected to decline rapidly due to a number of factors, such as: the removal of feed traffic previously supplied by Canadian Airlines, the inability of British Airways to participate in the frequent flyer program of the combined entity and the limited availability of slots."[37]

British Airways stated that:

> "...legislation to ensure that Air Canada's near monopoly does not extract a heavy price to consumers is essential."[38]

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[37] British Airways, *Competition in the Canadian Airline Industry: Bill C-26*, Summer 2000, page 4.

[38] Ibid, page 3.

"We believe that the correct approach to ensuring competition within Canadian markets consists of two main components: legislation that would ensure that competing carriers are able to gain access to the services and facilities controlled by Air Canada that they need to compete with the merged entity; and, legislation to prevent Air Canada from engaging in anti-competitive acts."[39]

Specifically, British Airways attached draft language for regulatory provisions in an Appendix, which was as follows:

"Draft regulations to be promulgated pursuant to Section 13 of Bill C-26 to Define Anti-competitive Conduct in Air Transportation Markets

i) alters its network or other infrastructure facilities for the purpose of or with the effect of disciplining or eliminating a competitor or otherwise substantially lessening competition in a market

ii) offers a discount, commission or other concession to a person or persons in respect of, or in connection with, domestic or international travel on the condition that such person or persons commit to purchase, acquire or book air transportation services for either domestic or international travel primarily from that carrier or based on an increased share of business from that carrier.

iii) uses a frequent flyer program, loyalty program or any non-price incentive for the purpose of or with the effect of disciplining or eliminating a competitor or otherwise substantially lessening competition in a market.

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[39] Ibid, page 2.

Draft regulation to be promulgated pursuant to Section 13 of Bill C-26 to Define Essential Services and Facilities in Air Transportation Markets

i) For the purposes of section 78, and in respect of air transportation markets, an essential "service" or "facility", without restricting the generality of these terms, includes: frequent flyer programs, interline services, maintenance services, baggage handling, loading and other ground services."[40]

The conditions also reflect terms and conditions attached by the European Commission to approval of cooperation between airlines. For example, the European Commission made its approval of the Austrian Airlines/Lufthansa "cooperation agreement" conditional on Austrian Airlines and Lufthansa making commitments pertaining to slots, frequencies, air fares, blocked space agreements, interlining, FFPs and intermodal services[41]. With respect to frequencies and air fares, the European Commission stated:

> "The parties agree not to add any frequencies on a particular new entrant city pair for a minimum of four consecutive IATA tariff seasons beginning with and including the tariff season in which the new entrant commences service on the new entrant city pair...
>
> Each and every time that the parties reduce a published fare on a new entrant city pair, they agree to apply an equivalent fare reduction (in percent) on three other Austria – Germany city pairs on which they do not have competition... For purposes of this commitment, a published fare shall include applicable IATA fares, carrier fares that are distributed to CRSs via the public tariff data base of ATPCO (Airline Tariffs'

[40] Ibid, page19.

[41] Notice pursuant to Article 16(3) of Council Regulation (EEC) No 3975/87 of 14 December 1987 concerning case IV/37.730 – Austrian Airlines Österreichische Luftverkehrs AG/Deutsche Lufthansa AG, *Official Journal of the European Communities*, 14 December 2001.

> Publishing Corporation) and fares marketed on the Internet where such fares are available to the general public.
>
> The three other comparable Austria – Germany city pairs where the parties will apply equivalent fare reductions will be determined as follows: The parties will choose two city pairs out of the next five largest Austria – Germany city pairs by passenger volume on which they do not have competition. The parties will not be subject to any constraints in selecting the third Austria – Germany city pair provided that it is a city pair on which the parties do not have competition."

In addition, the European Commission only gave its approval once competitors actually entered some of the markets in which the cooperation agreement raised the greatest competition concerns (Vienna – Frankfurt and Vienna – Stuttgart), and once it was satisfied that competitors would enter some of the other affected markets:

> "The main purpose of these commitments is to ensure that there can be viable new competition on the markets concerned by removing existing entry barriers for potential competitors. The Commission services received indications that there are a number of competitors which are interested in entering the market on the basis of these commitments. Under these circumstances, and to the extent that new entrants will have obtained the necessary traffic rights to operate on the relevant markets, the Commission envisages granting an exemption for the notified cooperation agreement."[42]
>
> "On the basis of the undertakings made by the Parties, the Commission could establish that several competitors are seriously interested in entering major routes between Austria and Germany. In fact, Adria Airways of Slovenia last year started flying twice a day on the Vienna – Frankfurt route and Air Alps operates a daily flight between Vienna and Stuttgart after Lufthansa and AuA volunteered to apply the remedies

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[42] At 356/5.

> even before the Commission took its final decision. In addition, two other airlines from central and eastern Europe have expressed a serious interest to enter two further major routes between Austria and Germany and a new Austrian airline, Styrian Airways, has been created which envisages to start operation on a significant number of additional routes this autumn."[43]

Virgin Atlantic also assumes that since re-authorisation of the RJSA will also require the approval of the UK Office of Fair Trading, a consensus will have to be reached between the ACCC and the OFT on any remedies to be applied.

[43] European Commission Press Release, *Commission clears partnership between Austrian Airlines and Lufthansa*, 5 July 2002.

Attachment A

COMMENTS ON THE IOD'S POLICY PAPER *"AIR WARFARE"*

The Air Services Agreement between the UK and the United States has been examined in close detail many times over the last decade or so; by governments, by legislators on both sides of the Atlantic, by consumer groups, think tanks and academics.

The latest paper, produced by the IoD, is one of the least thorough and adds nothing new to the debate. It has appeared only five months after the report of the Environment Transport and the Regions Select Committee of the House of Commons. That report was the result of extensive collection of written and oral evidence from a range of industry players and bodies, from the CAA and from the Government. It came to balanced conclusions about the issue. It did not call on the Government to sign an "open skies" agreement with the US without further ado.

By contrast, the IoD's paper appears to be the result of a basic literature search and little hard analysis. It takes little or no account of the nature of air services negotiations between the UK and the US or of some of the other realities which face the airline industry at Heathrow.

Negotiating with the US

- The US' aim in bilateral negotiations is simple: to promote and protect the interests of its own carriers. From its position of strength, with a domestic market which accounts for over a third of world aviation, the US has frequently forced other countries to agree to air service agreements which allow strong US carriers to obtain the upper hand in air service markets.
- This is as much the case with US open skies agreements as with classic bilateral agreements. Before the UK can accept an "open skies" agreement on the US model, it would be irresponsible if it did not either secure the interests of its carriers - for example, by gaining anti-trust immunity for alliances with a US carrier (as in the case of every other US "open skies" agreement); or study whether the other effects of such an agreement would not cause immediate, irreparable harm to the interests of UK carriers, including potential new entrants to the market such as British Midland.
- The IoD paper does not address either of these issues, nor does it recognise that the US' main interest is in securing agreements to benefit its own airline industry. The "benefits" of a US-model "open skies" agreement may flow to US carriers, not consumers or UK carriers.

- US politicians are well known for exercising their views on aviation. While certain Congressmen have been prominent in calling for more air services from London to cities in their congressional districts which host airline hubs, there have been few calls for true liberalisation to put UK and US carriers on an equal footing in the US and the EU. Not surprisingly, Congressmen are keen to promote and protect "home" interests. If they and others truly believed that consumer interests were paramount and that those interests would best be served by dismantling Bermuda II, they would have done so long ago.

Infrastructure constraints

- The IoD paper appears to confuse, at least in its summary, air traffic rights and airport slots. The two are different: a traffic right allows a carrier to offer a service between points; but without an airport "slot" - allocated under separate, impartial procedures - the carrier cannot physically use the airport runways and terminals and operate the service.

- The paper touches on the problem of the severe infrastructure constraints at Heathrow - which is manifest in the lack of available slots - noting in its Summary that liberalisation must be accompanied by a decision to build Terminal 5. However, the paper does not elsewhere take sufficient account of the lack of available runway and terminal capacity, and the time it will take to remedy this (it will be at least a further 5 years before Heathrow Terminal 5 can be completed, once the Government has decided whether or not it can be built). New capacity simply won't be available at Heathrow in the short to medium term.

- The paper does not follow this issue through to its logical conclusion. Briefly stated, Heathrow as it currently stands is full. The corollaries of this are that:

    - an "open skies" deal with the US can only introduce new carriers or services from Heathrow to the US by displacing other services;
    - under "open skies," all flights from Gatwick to the US could transfer to Heathrow; this amounts to more than 30 flights a day displacing other services from Heathrow;
    - the services displaced are likely to be those to UK domestic points, thus reducing access from the regions to Heathrow's long-haul network (including the complete closing of some existing routes from Heathrow); and unprofitable services to long-haul destinations, thus reducing Heathrow's and London's attractiveness to businesses because it will no longer be the world's aviation hub;
    - however, the process of introducing new Heathrow-US services would inevitably be gradual because there is so little room for them,

and would not add large amounts of new capacity to the market; so there would not be any significant change in the current balance of supply and demand. There would therefore be no great change in the levels of fares.

- The paper suggests that lack of capacity does not affect prices at other slot-constrained airports such as Chicago (section 4). In fact, the US Congress General Accounting Office found in March 1999 that fares from Chicago O'Hare had risen by an average of 4.9% between 1994 and 1999 in the same period that average fares from all US airports serving large communities had fallen by 4%.

The true state of competition

- Competition on routes from Heathrow and Gatwick to the US is fierce. From London to New York, 3 US and 2 UK carriers currently operate up to 31 flights a day. In addition, two 5th freedom carriers offer services, one of them operating daily flights. This is the densest, most competitive long-haul market in the world. By comparison, there are currently only 6 flights a day from Frankfurt to New York, operated by 4 carriers - two of which cooperate closely with each other!

- There are direct flights from London to more US cities than from any other European point, to 28 airports all over the US. By contrast, there are direct flights from Frankfurt to only 17 US airports.

- Similarly, other major US cities such as Chicago and Los Angeles are served by up to five carriers with non-stop daily services and by other carriers indirectly.

- Carriers compete on many levels: price (including through corporate discounts and upgrading policies); service and product; differentiated classes of service; and schedule.

- Although the IoD paper states that neither BA nor Virgin sells-on excess business class seats at lower fares (section 4), lower price business class fares are available for travel on these airlines (through different methods of distribution), and both offer products more spacious and comfortable than economy class (eg BA's World Traveller Plus) at fares lower than business class fares from any other European city.

- Indirect business class fares from London to the US are often cheaper than similar fares from continental European points.

Bermuda II has grown over time

- The Bermuda II agreement has grown considerably, responding to market needs - including requests for new US gateways from airlines on both sides. The UK and the US negotiated major changes to Bermuda II in 1980, 1991 and 1995. There are far more flights to more US cities from London than from any other European city. It is quite possible that under a US "open skies" agreement, the number of US cities served from London would actually decrease (the number of airlines serving some UK-Germany airport-pairs has, for example, decreased).

- Existing opportunities under Bermuda II for UK and US carriers to operate new services from Gatwick have not been fully taken up. For example, Delta has been able to announce a new service between Boston and Gatwick; and British Midland could request designation to fly on some routes out of Gatwick.

- There are no constraints on airlines which wish to serve US points from UK airports other than Gatwick and Heathrow. For instance, they can operate from Stansted or Birmingham, both of which offer viable alternatives for passengers from parts of the Gatwick and Heathrow catchment area.

The US model is not a panacea - nor is Bermuda II a great restraint

- In 1998, UK-US scheduled passenger numbers grew by 5.1 per cent - faster than the two next biggest markets, Germany-US and Netherlands-US, both of which have US model "open skies" agreements in place. US-style "open skies" agreements are no guarantee of continued traffic growth. And in the case of Frankfurt-New York, for example, they are no guarantee of better service or greater competition.

Liberalisation

- The IoD paper tries to dismiss a number of valid objections to the form of liberalisation involved in signing a US-style "open skies" deal. These objections mainly involve the imbalance in UK carriers' rights to gain access to traffic from the US hinterland, compared with the freedom US carriers would gain to draw traffic from London's hinterland, the EU.

- The EU now forms a single aviation market. A number of EU states (eg Germany, Netherlands, Belgium) have signed US-style "open skies" agreements. US carriers therefore have the freedom to operate intra-EU flights between those states. Unless UK carriers are granted either anti-trust immunity for alliances with US carriers, cabotage rights or ownership

rights in the US, they have no similar access to US hinterla
some routes, this traffic is the majority of traffic carried by

- In BA's case, US behind-gateway traffic remains an import
overall traffic which BA wishes to carry. BA believes that i
regulatory environment, the best way to access that traffic
immunised alliance with a US carrier. However, BA has in
gain access by investing in a US carrier. US ownership anc
which are considerably more restrictive than the EU's - ma
impossible to achieve effectively, which in turn influenced
decision to disinvest.

- The US ownership and control laws and regulations remai
barrier to global consolidation in the airline industry. As lc
remain in place, it will be impossible for any non-US carrie
global airline champion in the way that European compani
industries such as Vodafone, Daimler and Nestle have bee

- US rules in other areas such as the "Fly America" policy ar
also act against UK interests and are not reciprocated by E

- Negotiating an "open skies" agreement with the US gives
to address some or all of these issues. If the UK simply si
skies" agreement without, for example, approval for anti-t
for UK carriers with US carriers, it would perpetuate the r
imbalances which favour US carriers while failing to gain a
could benefit consumers.

Conclusion

- The IoD paper's assertion that "Liberalisation would bring
business class fares between the US and UK from Heathro
number of simplifications. These are not soundly based:

  - Bermuda II is not an onerously restrictive agreemen
new market entry by further UK and US carriers; it
growth in services; and it does allow both sides to s
new gateways. As a result, UK-US routes are the m
contested long-haul routes in the world.
  - The UK's objectives for liberalising UK-US air servi
US-style "open skies" model are worthwhile; rejecti
start of a negotiation with the US would be poor ne
and would work against the interests of UK carriers
by blocking off the chance to obtain balanced benef
  - Business class fares between Heathrow and the US
be driven by the special characteristics of this marke

requirements of business travellers for high levels of service, frequency and flexibility and by the extreme constraints on infrastructure at Gatwick and Heathrow. Travellers will continue to have a wide range of opportunities to travel on indirect routings from London to US destinations, at lower fare levels. Signing an "open skies" deal would not bring business class fares for direct flights down nor bring significant new benefits for consumers.

Government & Industry Affairs
British Airways plc
January 2001

Attachment B

Competition in the Canadian Airline Industry

Bill C-26

British Airways

A Proposal for Sustainable Competition in the Canadian Airline Industry

British Airways believes that legislative or regulatory changes are necessary to ensure that all Canadians enjoy the benefit of a sustainable and competitive domestic aviation industry. While the merger was approved on valid public policy grounds given the impending failure of Canadian Airlines, there is a significant risk that as a result of the merger, the combined entity has the ability and incentive to extract monopoly profits at the expense of the Canadian consumer and the Canadian economy.

We believe that the correct approach to ensuring competition within Canadian markets consists of two main components: legislation that will ensure that competing carriers are able to gain access to the services and facilities controlled by Air Canada that they need to compete with the merged entity; and, legislation to prevent Air Canada from engaging in anti-competitive acts. An approach similar to that proposed has been adopted by authorities in a number of jurisdictions, including Australia, South Africa, Europe and the United States.

Bill C-26, together with effective regulations promulgated pursuant to the statutory provisions, can provide an effective regulatory framework to permit sustainable competition in Canadian travel markets.

Substantial Lessening of Competition in the Canadian Airline Industry

It is beyond doubt that Air Canada has acquired unprecedented dominance, more accurately a near monopoly in most domestic markets and a monopoly on many key domestic routes. The merger between Air Canada and Canadian Airlines has, as concluded by the Commissioner of Competition, led to a substantial lessening of competition both in respect of domestic airline markets in Canada and certain international airline markets. This enables the combined entity to engage in anti-competitive practices or behavior unless restrained by legislation. A combined Canadian Airlines and Air Canada will hold approximately 85% of the domestic passenger market generally within Canada, and a near monopoly on many domestic and international routes. In contrast, other airline markets in developed nations have the benefit of a large number of competitors for domestic flights, such as the United Kingdom with has a number of domestic carriers.

The vast distances and relatively sparse population in Canada create a unique need for air transportation services with little effective competition from ground transportation for most consumers, particularly time-sensitive or business travellers. Air Canada's domestic market share is essentially a market share of all transportation modes, as may be distinguished from other markets such as the United Kingdom, France and Hong Kong, where there are effective surface competitors. The greatest distances in the UK and France are similar to the distance between Toronto and Montreal.

The Canadian airline industry has also undergone significant consolidation and concentration over the past two decades. In the 1980s, there were seven separate domestic carriers serving the Canadian

market: Air Canada, CP Air, Pacific Western Airlines ("PWA"), Wardair, Nordair, Eastern Pacific Airlines ("EPA") and Transair. CP Air purchased EPA and Nordair. PWA then purchased Transair and later CP Air to form Canadian Airlines. In 1989, Canadian Airlines purchased Wardair. By 1989, there was a duopoly within the domestic airline industry in Canada consisting of Air Canada and Canadian Airlines. As a result of the present transaction, Air Canada has eliminated Canadian Airlines as a competitor and now holds a near-monopoly over domestic airline markets in Canada. Given this historical trend towards consolidation within the Canadian airline industry, it is unlikely that any new entrant will significantly challenge Air Canada's near-monopoly status.

The other factor that heightens the effects of dominance or monopoly is that air transportation is not fully deregulated in the sense that there are foreign ownership restrictions and prohibitions against foreign carriers servicing domestic markets. The Competition Tribunal, the Competition Bureau and the House of Commons Standing Committee have all noted that these are significant barriers to entry. As a result, legislation to ensure that Air Canada's near monopoly does not extract a heavy price to consumers is essential.

Canada/UK Air Transportation Markets

British Airways has been serving the Canadian market since 1947. However, due to a number of factors, the position occupied by the combined entity threatens the ability of British Airways to continue as a vigorous competitor to Air Canada on Canada-UK routes. In its report to the Minister of Transport dated October 22, 1999, the Competition Bureau was primarily concerned with the effect of the proposed transaction upon the domestic airline market. In addition to competitive overlap in the domestic Canadian market however, Air Canada and Canadian Airlines also compete on two international routes: Canada and London; and, Canada and Hong Kong.

The data collected by the Civil Aviation Authority in the United Kingdom ("the CAA") shows that there were just under 2.5 million scheduled passengers between the United Kingdom and Canada in 1999. This figure includes non-revenue passengers. The data show that these passengers were divided between Air Canada, British Airways and Canadian Airlines 46%, 30% and 24%, respectively.

The CAA conducts a survey at various airports. In 1999 the airports included all the London airports and Manchester, which accounted for 97% of all scheduled passengers between the United Kingdom and Canada in that year. Amongst other things, that survey identifies whether passengers are connecting at their destination. It shows that 18% of all passengers connected at the Canadian end. This shows the importance of interline access to the destinations beyond the main gateways. These slightly under 500,000 passengers now face a monopoly on these routes to cities such as Halifax, Ottawa and Calgary unless Air Canada is required to enter into competitive interline arrangements.

The table below shows which direct routes had scheduled service in 1999 and which airlines provided it and the numbers of passengers on the routes in the year.

Route	Airlines			Passengers (000)
Glasgow - Toronto	AC			72
London - Edmonton	AC			31
London - Halifax	AC			88
London - Ottawa	AC	CP		145
London - Montreal	AC		BA	296
London - Vancouver	AC	CP	BA	474
London - Calgary	AC			247
London - Toronto	AC	CP	BA	1023
Manchester - Toronto	AC			75

The merger eliminates direct competition on one route and reduces it on two others.

The most significant change is on the London - Toronto route. On this route, in Summer 1999, Air Canada operated four flights per day, which was matched by British Airways and Canadian Airlines jointly[4]. This Summer Air Canada/CP is operating five daily services and British Airways two. It is very difficult to impossible for British Airways to increase its frequency on the route because of lack of slots at Toronto, where Air Canada controls 80% of the slots. In any case, even if British Airways could acquire slots at an appropriate time in Toronto, shortage of available slots at Heathrow would mean that it could probably only increase frequency to Toronto at the expense of another route. British Airways' market share is expected to decline rapidly due to a number of factors, such as: the removal of feed traffic previously supplied by Canadian Airlines, the inability of British Airways to participate in the frequent flyer program of the combined entity and the limited availability of slots.

Maintaining the competitiveness of the established full service scheduled competitors on international routes is vital to a sustainable competitive domestic airline industry in Canada. An existing or new domestic carrier may wish to negotiate an interline or code sharing agreement with an existing international carrier, such as British Airways. Competitive interline agreements would provide important feed traffic required for the continued survival or sustained entry of the domestic carrier. In the event that these existing competitors on international routes, such as British Airways, do not remain as viable competitors however, such a domestic carrier would not have any other alternative but to negotiate interline and code sharing agreements with the combined entity. As recognized by the Competition Bureau, the merged entity may not have an incentive to negotiate with a new domestic carrier as it has its own regional network. Maintaining existing international carriers as

[4] British Airways and Canadian Airlines operated the route under a commercial agreement, code-sharing on each others flights and sharing revenues.

effective competitors on international routes is therefore an essential component of ensuring a competitive domestic airline industry.

British Airway's Submission Regarding Legislative and Regulatory Changes

In the unique Canadian market, regulatory or legislative changes are necessary to ensure that the remaining competition to Air Canada can continue to compete effectively and operate in an environment without the additional cost associated with the potential anti-competitive behavior of the merged entity. Although British Airways does not generally support increased regulation, the current situation resulting from the merger creates an unprecedented potential for anti-competitive behavior. In markets where a merged entity acquires the ability to profit from anti-competitive behavior, many practices which would otherwise be a pro-competitive response can be used for the objective of eliminating or disciplining remaining competition. For example, predatory pricing is not economically rational unless the entity engaging in the practice has a reasonable prospect of eliminating a competitor so that increased profits can be achieved following the exit of that competitor..

British Airways has been actively co-operating with the Competition Bureau and the Ministry of Transport in their efforts to implement legislation that would address the significant competition concerns resulting from the merger. As part of these efforts, British Airways appeared together with Air France and Cathay Pacific before the House of Commons Standing Committee to discuss legislation proposed by the Canadian government entitled Bill C-26.

Although Bill C-26 incorporates a number of undertakings provided by Air Canada to the Commissioner of Competition (the "Undertakings"), these undertakings are limited in their application to domestic markets and do not address competition on international routes. For example, the Undertakings require Air Canada to make available its frequent flyer points to **domestic** airlines on commercially reasonable terms. Similarly, the Undertakings require Air Canada to enter into interline arrangements in accordance with IATA standards and joint fare agreements, on commercially reasonable terms, in respect of **domestic** airlines, provided that the carrier meets reasonable industry standards. The Undertakings do not however, provide access to Air Canada's frequent flyer programme to carriers operating on international routes or require competitive interline agreements with such international carriers.

International travel markets are important to Canadian consumers. International and trans border travel accounts, by some estimates, for over 50% of the dollars spent by Canadian consumers. As part of the submissions before the House of Commons Standing Committee British Airways, jointly with Cathay Pacific and Air France, expressed its concerns with the respect to the impact of the merger upon competition on international and domestic routes for time-sensitive travellers. As noted, Bill C-26 did not address competition on international routes and further, did not provide adequate protection to ensure that the Canadian domestic and international air travel markets remain competitive. In particular, British Airways's submissions focussed upon four main areas of concern. the absence of competitive interline and code share arrangements with the merged entity; the need

for access to the frequent flyer programme of Air Canada/CP; the potential for anti-competitive conduct by the merged entity; and the distribution of airport slots.

These submissions are consistent with the recommendations made by the House of Commons Standing Committee in its report issued in December 1999. We have focussed on three key recommendations:

- that the Governor in Council be given the power to specify, by regulation, anti-competitive acts or conduct by air carriers;
- that a dominant carrier allow new entrants and existing carriers to purchase points in its frequent flyer program; and
- that a dominant carrier negotiate interline agreements under commercially reasonable terms and conditions with all new entrants and existing carriers.

The Committee also recommended that there be greater foreign competition through liberalized ownership restrictions and elimination of prohibitions against cabotage. These restrictions were not removed making it even more important that the recommendations of this Committee be followed in respect of both competition in domestic markets and international markets.

In other jurisdictions where similar concerns have arisen through deregulation of state industries or merger activity, competition policy has been invoked in two ways to ensure that competitive markets are maintained:

- legislative provisions to ensure that competitors have **access to essential facilities and services** to permit them to compete; and
- legislative provisions to **prohibit abuse of dominance**.

We have set out below the way in which these provisions, now included in Bill C-26, can address the specific issues raised above.

Need for Competitive Interline Arrangements

Prior to the merger, British Airways had competitive interline agreements and code share arrangements with Canadian Airlines for over 1,000 flights per week, including flights from London to each of twelve cities in Canada, such as Ottawa, Halifax, Quebec City, Winnipeg, Edmonton, Calgary and Victoria. Following the merger, the code share and competitive interline arrangements between Canadian Airlines and British Airways were cancelled. As a result, Air Canada will now have an effective **monopoly** on flights between London and the twelve cities in Canada that were previously competitively served by Canadian and British Airways.

The Undertakings provided by Air Canada to the Canadian Commissioner of Competition with respect to interlining agreements are restricted to domestic carriers. To address the concerns noted above and given the unprecedented domestic market position which Air Canada has acquired as a result of the merger and the unique characteristics of the Canadian air transportation market, British Airways has recommend that Air Canada be required to provide access to its domestic network through competitive interline and prorate arrangements with international carriers under reasonable and competitive terms. The purpose of this is to permit other international airlines to compete viably with Air Canada on routes such as London - Winnipeg which they do not serve directly themselves.

Feed traffic is important in providing service over a network of scheduled flights. It permits to serve markets it otherwise could not competitively serve and allows for more frequent service. In markets where international carriers have alternatives for feed traffic, there is no difficulty entering into interline agreements at competitive rates; for example, Air Canada has a choice of airlines with which to interline to all significant points in Europe behind its gateways. As a result of the merger, there is no alternative for feed traffic in Canada and Air Canada will have no incentive to enter into interline agreements at competitive prorates.

The absence of such interline and code share agreements is a major concern for consumers. Without reasonable prorate and interline arrangements with international airlines in place, consumers in markets such as London - Winnipeg will be left without the competitive choice which they have previously enjoyed. Even if Air Canada were to agree to enter into interline agreements the price or "prorate" charged to other carriers would be arbitrarily set by Air Canada. Prorates are portions of through fares received for journeys over more than one carrier that the carriers allocate as compensation between themselves. Competitive prorates are typically based on the proportionate shares of ticket revenues based on the miles flown with that carrier. Absent competitive prorates, there will be no effective competition from other carriers resulting in significant regional economic distortion in favour of those gateway cities that benefit from competition by international carriers, such as Toronto, Montreal and Vancouver.

British Airways concerns were confirmed when it learned that Air Canada had recently filed air fares between key Canadian cities which are almost 200 percent higher than the previous levels. For example, a ticket for travel from London to Ottawa via Toronto on British Airways in business class would currently include $389 as Air Canada's portion for the Toronto-Ottawa one-way fare. These levels have been increased from $389 to $1,143, thus effectively pricing international airlines out of the Ottawa market completely. The same applies to several other Canadian cities. We believe that the inability of international airlines to compete with Air Canada on these routes is highly detrimental to both Canadian and international consumers. A detailed examination of this issue is attached as Appendix "A".

Requiring Air Canada to enter into competitive interline agreements is consistent with the remedies imposed in respect of many mergers and commercial agreements considered by European authorities including both the KLM/Alitalia and Lufthansa/SAS decisions of the European Commission. In both cases, the parties provided an undertaking that they would enter into interline agreements with any

new entrants. For example, the Commission ordered as follows in respect of Lufthansa and SAS:

> "An airline established in a Member State of the EEA and operating services on one or more of the routes referred to in Article 2(2) may ask to sign an interlining agreement with Lufthansa and SAS on the route or routes in question. Lufthansa and SAS shall sign an agreement in accordance with the conditions that are normal in the industry."

Similarly, in *British Midland v. Aer Lingus* (26 February 1992) the European Commission examined whether the refusal by Aer Lingus to enter into an interline agreement with British Midland in respect of flights between London and Dublin amounted to an abuse of dominance. The Commission characterized the refusal to interline as a "serious handicap" for British Midland. It went on to set out the following general principles:

> "Whether a duty to interline arises depends on the effects on competition of the refusal to interline; it would exist in particular when the refusal or withdrawal of interline facilities by a dominant airline is objectively likely to have a significant impact on the other airline's ability to start a new service or sustain an existing service on account of its effects on the other airline's costs and revenue in respect of the service in question, and when the dominant airline cannot give any objective commercial reason for its refusal (such as concerns about creditworthiness) other than its wish to avoid helping this particular competitor"

The above principle applies to the situation here, where Air Canada holds a monopoly in respect of the routes that carriers such as British Airways previously served through interline agreements with Canadian Airlines.

Participation in the Frequent Flyer Program of Air Canada

In its annual report for the year 1998, Air Canada said the following, demonstrating both the importance of FFPs and that a requirement that they give access to its own FFP to others does not represent a burden.

> "Canadians may be the most avid points collectors on earth, and Aeroplan points are one of Canada's favorite collectibles. Often overlooked when pundits try to assess the financial impact of frequent flyer plans are the huge revenues earned by Aeroplan from selling the billions of points given out each year by the program's hotel, car rental, credit card and other partners. Aeroplan now has over four million members, and is adding 40,000 a month. The goal is to boost revenues by a further 20 percent this year and do a major relaunch - with additional products and partners and a new

orientation that weights rewards towards the value of a customer's patronage, not just miles flown."

In *Canada (Dir. Of Investigation and Research) v. Air Canada,* the Competition Tribunal identified that a widely accepted FFP was required for successful entry into the Canadian airline industry. Further, the Canadian Competition Bureau has stated that a widely accepted FFP is "very important to attracting and retaining business travellers". Similarly, the Senate Standing Committee recognised that "frequent flyer programs are a well-established marketing tool" and that "the inability to offer a comparable plan to the big carriers can be a decided disadvantage".

In many mergers and commercial agreements considered by European authorities, including both the KLM/Alitalia and Lufthansa/SAS decisions of the European Commission, the airlines concerned have been required to give access to their Frequent Flyer Programs ("FFPs") to airlines which seek to compete with them on routes where competition will be reduced or lost, when that airline does not participate in a comparable scheme. In British Airways's view this is not a remedy which is ordinarily important in competitive marketplaces. FFPs are used by airlines as competitive tools, to distinguish one from another. Therefore airlines will tend not to be as interested in the FFP of a direct competitor but rather in some scheme which competes with that offered by the direct competitor. However, in Canada the situation is unusual, the marketplace will not be properly competitive and there is no other FFP scheme than Air Canada/CP's which a competitor can participate in and which may be as attractive to consumers.

Air Canada's international competitors will have far too small a presence in Canada to be able to offer attractive schemes themselves, particularly because of the importance in Canada of domestic air travel. Air Canada now has 99% of all Canadian members of FFPs. British Airways has only 50,000 Canadian members in its FFP compared with the 5,000,000 which the merged entity has. Previously, British Airways had reciprocal arrangements with Canadian Airlines in respect of FFPs, which made its scheme fully competitive with Air Canada's program.

To ensure that international and domestic competitors are not disadvantaged by the lack of an alternative well-established FFP in Canada, British Airways has suggested that Air Canada should be required to make access to its FFP available on reasonable and competitive terms, similar to what it offers to hotels and car rental companies..

Leveraging the domestic monopoly

AC's near-monopoly on domestic routes affords it an opportunity to leverage that position to reduce competition in international air travel markets through the use of incentive programmes. Although British Airways believes that, as a generality, it is entirely proper for an airline to offer incentives that are linked to the amount of travel which is booked on that airline, it does not believe that this extends to a situation where an incentive is offered to a customer on a route or bundle of routes on which the

airline is in a monopoly position conditional upon the customer's also acquiring a significant part of its requirements in another, competitive market. Air Canada has instituted programs which offer discounts on domestic travel within Canada in exchange for a higher share of international business. As a result, AC's near monopoly in the domestic Canadian market is being leveraged against international competitors to permit Air Canada to secure a further share of the international market.

Bill C-26 Amendments

Prior to amendment Bill C-26 did not adequately address these concerns. British Airways, Cathay Pacific and Air France jointly testified before the House of Commons Standing Committee and proposed certain amendments to the Bill. Among those amendments was the inclusion of an essential facilities provision that is intended to prevent Air Canada from lessening or eliminating competition by refusing to grant access, or only granting access on discriminatory terms, to essential facilities or services which other competitors require to compete.

The essential facilities doctrine has been applied or expressly codified in a number of jurisdictions, including the U.S., Australia, Germany, South Africa, Europe and the U.K.. It prevents a dominant competitor from lessening or eliminating competition by refusing to grant access, or only granting access on discriminatory terms, to essential facilities or services which other competitors require to compete. The essential facilities doctrine has been specifically applied in the transportation sector by the European Commission to cause a dominant carrier to interline at competitive prorates on domestic routes.

This amendment proposal was fully supported by the Competition Commissioner. Canadian competition authorities have recognized the need for an "essential facilities" doctrine. However, the *Competition Act* does not provide a remedy equivalent to that doctrine so as to ensure access to

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The Restrictive Trade Practices Commission("RTPC") in its 1986 report *Competition in the Canadian Petroleum Industry* examined the issues associated with major oil company dominance of petroleum refineries, product terminals and pipelines and their vertical integration downstream into petroleum product marketing where they competed against rivals who were dependent upon the refiners for their supplies of heating oil and gasoline. The RTPC set out its views on the refusal to supply by a person with market power, relying upon the "essential facilities" doctrine as applied by U.S. courts:

> In the Commission's view power over supply, particularly in markets characterized by pervasive vertical integration, carries with it a responsibility not to refuse to supply unless there is a legitimate business reason for doing so, or what the United States Supreme Court has referred to an "efficiency justification". Arbitrary refusals to supply in such circumstances inhibit entry and expansion and dampen market forces... The Courts in the United States have developed a set of principles ... known as the "essential facilities" or "bottleneck" doctrine, **which define more precisely the duty to supply on the part of one or more firms who control a scarce facility, access to the benefits or output of which is necessary to compete effectively.** [emphasis added]

essential facilities by competitors.[··] As noted in the responses from the Competition Commissioner and his staff to questions from this Committee on April 12, 2000, such as those from the Chair concerning the cancellation of ground services contracts with Canada 3000, the *Competition Act* does not have a provision to adequately deal with this problem.

The essential facilities amendment will address the need for competitive interline agreements, access to ground services and participation in Air Canada's frequent flyer programs in certain circumstances. Such solutions are not unheard of in Canadian legislation. The *Canada Transportation Act* requires that the competing rail companies are required to provide access to their network and facilities on agreed tariffs. In the event that the parties cannot agree, then the Canadian Transportation Agency is empowered to determine the appropriate rate. Similarly, dominant telecommunications companies have been required to provide access to their network facilities to permit other competitors to compete.

The essential facilities amendment is particularly important when it is noted that the undertakings given by Air Canada, do not effectively address the issue of access to essential facilities and services such as interline arrangements or ground services for the domestic carriers it was intended to protect. All IATA members, such as Air Canada interline with other IATA members. However, IATA rules do not govern the price or "prorate" at which interline agreements are entered into. Therefore, the undertakings by Air Canada to enter into interline agreements with certain domestic carriers "in accordance with IATA standards" on "commercially reasonable terms" does nothing to provide for **competitive** interline agreements.

We also were assured by the Competition Commissioner that the provision dealing with abuse of dominance and the regulations which will be promulgated pursuant to the amendments will apply both to domestic and international routes. Section 13 of Bill C-26 proposes an amendment to the

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[··] Consistent with this view, comments from the Deputy Director of Investigation and Research (Civil) question whether the current *Competition Act* is capable of providing a remedy based on the essential facilities doctrine. Gilles Ménard stated in an address delivered on May 10, 1996:

> A second issue relates to the applicability in Canada of the essential facility doctrine developed in the United States. In many industries that are subject to deregulation, an incumbent firm was given some monopoly power to compensate for some public duty it was responsible for carrying out. Often these firms are in control of facilities that new entrants need access to in order to become competitive. **This raises the issue as to whether the current *Act* is capable of dealing with these new problems. ...**
>
> While [the essential facilities] doctrine has some relevance to the abuse of dominance and refusal to deal provisions of the *Competition Act*, **it is not directly relevant to the Canadian courts. It is worth noting in this regard that in none of the cases brought before the Tribunal did the Director refer to the doctrine.**

"Abuse of Dominance: Some Reflections on Recent Cases and Emerging Issues" Remarks by Gilles Ménard, Deputy Director of Investigation and Research (Civil Matters), Conference of the Canadian Institute on Competition Law and Business Practices (May 10, 1996)

Competition Act to address anti-competitive practices engaged in by a person "operating a domestic service". We were concerned that this section and the regulations to be issued under it would be interpreted as applying to anti-competitive practices in domestic markets only.

A failure to apply the regulatory framework to protect competition in international markets would be a particularly glaring inadequacy of Bill C-26 given the importance of international and trans border travel to Canadian consumers. Furthermore, it is unheard of to engage competition policy which protects only domestic competitors and ignores anti-competitive effects in international markets which directly impact consumers. In fact it is contrary to the both the implicit and explicit obligations associated with bilateral relationships between nations. It has often been noted that deregulation and liberalization of trade restrictions, such as "open skies" is dependant on effective enforcement of competition laws. In fact, the Bilateral Treaty between Canada and the United Kingdom in respect of Air Transport includes three basic governing principles:

(a) fair and equal opportunity for carriers of both nations;

(b) an obligation to eliminate all forms of unfair competition adversely affecting carriers of both nations; and

(c) to take into account the interest of carriers from both nations.

The Bilateral Treaty between Canada and both France and Hong Kong provides for similar governing principles:

(a) fair and equal opportunity for the designated airlines of both Contracting Parties to operate the agreed services; and

(b) the designated airlines of each Contracting Party shall take into account the interests of the designated airlines of the other Contracting Party so as not to affect unduly the services which the latter provide.

This again highlights the need to ensure that the amendments in Bill C-26 will address competition concerns both in domestic markets and international markets.

To this end we submit that the regulations that define anti-competitive conduct and access to essential facilities must clearly apply both to domestic and international markets. Therefore, we support the draft regulatory provisions submitted by the Competition Commissioner on April 12, 2000 to the House of Commons Standing Committee and have provided comments on those provisions to the Commissioner as he requested. We have also attached draft language for regulatory provisions pursuant to the authority provided under s.13 of Bill C-26, which would identify the potential anti-competitive conduct in Appendix "B"

Conclusion

British Airways continues to closely monitor the legislative process. It remains concerned that an effective regulatory framework is necessary to preserve what remains of competition in the Canadian airline industry. In particular, these proposals brought forward by Bill C-26, as amended, require that certain regulations define the conduct that will be prohibited as anti-competitive and to describe those facilities to which Air Canada will be required to grant access under the essential facilities provision. Without these regulations the provisions in Bill C-26 will have no real effect on these issues. We intend to make submissions to the Senate Standing Committee on Transport urging them to make specific proposals for regulations that should be promulgated pursuant to these provisions.

British Airways believes that the merger has brought about a situation in which Air Canada can behave in a way which would deprive many consumers of effective choice. Moreover, it has already behaved in a way that damages competition, through action in connection with prorates and incentive deals, thereby confirming the real nature of the risk.

The Competition Commissioner mad e submissions to the House of Commons Standing Committee that it should not be concerned about Air Canada's profitable future, a confidence which has also been expressed recently by the stock market. Air Canada has also cleared an important hurdle with Canadian successfully emerging from its CCAA proceedings clearing the way for the completion of the full merger of Air Canada and Canadian. Furthermore, it is important to note that none of the solutions proposed will cost Air Canada anything other than the ability to extract monopoly profits from consumers.

Competing carriers should be able to purchase frequent flyer points at the same price that they are regularly sold by Air Canada to hotels, car rental companies and alliance partners, further contributing to the profitable use of its FFP as noted in its annual report.

We believe that the amendments to Bill C-26 coupled with solid regulations will ensure that all Canadians enjoy the benefit of a competitive marketplace. Competition is always the best solution to ensure consumers receive competitive prices, good service and product choices.

Appendix "A"

Notes concerning the prorate issue

This document comprises two separate notes. The first provides a simple explanation of what airlines mean when they talk about prorating in respect of passengers' fares and the second sets out why international airlines are worried about the possibility of abuse of the system by Air Canada, now that it has a monopoly on so many important domestic routes.

GUIDE TO AIRLINE PRORATING

Airlines often set through fares for journeys which involve more than a single flight, rather than charge the separate fares which would apply for the individual flights. Thus, for example, Air Canada offers a fully flexible fare of $2256 for travel from Thunder Bay to Frankfurt which allows transfer between flights at, amongst other places, Toronto. The equivalent fares for Thunder Bay to Toronto and Toronto to Frankfurt are $584 and $2099, respectively, adding to $2683. Thus the through fare provides a saving of $427 or 16% over the fares for the separate legs.

In the example above all the travel is on a single airline, so that apportionment of the through fare is of no consequence but the same practice - through fares at less than the sum of the fares for the separate legs - applies with respect to many journeys which involve more than one airline. For example, British Airways offers the same fares as Air Canada for each of Toronto and Thunder Bay to Frankfurt even though it can carry passengers only between Toronto and Frankfurt and therefore needs to use another airline for the Thunder Bay - Toronto leg. This inevitably raises the issue of how the through fare should be apportioned between the two airlines involved. Within the industry an agreement, to which most airlines adhere, has been reached on how this should be done (the Multilateral Prorate Agreement or MPA).

The basic method of allocating a fare between participating airlines is known as straight-rate prorating ("srp"). Under srp the fare is divided up between the airlines in proportion to their shares of the 'prorate mileage' of the journey. However, the system allows an airline to file a 'proviso' in respect of any part of the journey which is on its services, provided that sector is not more than 3000

The fares quoted were as shown in CRSs on 4th May 2000 for travel on 1st June 2000.

The journey would involve a connection between BA services at London.

Prior to the Air Canada take-over of Canadian, BA would have used Canadian but now must use the combined entity.

The prorate mileage for the journey is the sum of the prorate mileages for each leg. The prorate mileage for a leg is the product of the great circle distance between the end points of the flight multiplied by a factor to take account of relative differences in unit costs between short and long flights and between flights of similar length in different parts of the world.

prorate miles. Provisos are usually specified as proportions of the sector fare. For example an airline may specify that it requires to receive the same amount as it charges passengers for its part of the journey on a stand-alone basis or it may say it requires 90%, 80% or some other percentage of that fare; sometimes it will specify different percentages for different types of fares (for example 90% for unrestricted fares or 60% for low promotional fares). Different provisos may also be specified for different types of journey (for example 80% for a sector which is part of a journey wholly within North America and 100% for the same sector when it forms part of any other journey). When there are provisos filed for sectors of a journey, they are taken out of the fare and the balance is prorated using srp over the balance of the journey. In some cases the effect of these provisos could be to leave one participating airline with next to nothing for its sector; indeed the provisos could add up to more than the fare. There is, therefore, a protection built into the system, which is such that if any airline would receive less than a specified amount then all provisos are ignored and proration is completed using srp.

Clearly, for this system to work there is a need to know the prorate mileage and airlines' basic fares for each sector that may appear in a journey. This information is gathered by an agency, "The Prorate Agency", and published to all the airlines quarterly, along with airlines' prorate provisos.

For North American airlines the basic fares are captured from the airlines' fares filings submitted to ATPCo, the agency used by all such airlines to file fares with regulators, where necessary, and with the computer reservation systems ("CRSs") used by travel agents and others for obtaining information about available flights and fares and for making bookings. For all other airlines, the data are captured from manual filings made with the prorate agency in accordance with specified rules.

In addition to the MPA, many airlines have bilateral agreements with other airlines covering the way that revenues on all or particular journeys involving the two of them shall be divided. Alliances sometimes extend these agreements to multilateral ones involving several or all the members.

Air Canada would sell a fully flexible economy ticket from Toronto to Cairo for $2533 which permitted the passenger to fly via any number of intermediate stops. If the passengers chose to stop at London and then fly to Brussels with Sabena, on to Zurich with Swissair, to Athens with Olympic and finally to Cairo with Egyptair and each of those airlines applied a prorate proviso requiring its full sector fare, then Air Canada would be required to pay them $473, $576, $1144, and $470, respectively, a grand total of $2663 or $130 more than Air Canada had collected for the entire journey.

The specified amount is calculated in effect by multiplying the prorate mileage for the sector concerned by a rate per mile, specified in US cents and adjusted annually in accordance with a fixed formula. The amount is currently 8.8 cents.

A basic fare is determined for each cabin class (e.g. First, Business and Economy) which an airline offers on the sector.

The basic fare captured for North American airlines is the highest unrestricted fare for the particular class available for sale for the sector at the date of capture.

The rules require that the fare is available for sale for travel on the sector on a specified date (the first day of the quarter concerned). Although airlines may file as their basic fare any fare meeting this condition in practice they usually file the highest such fare, replicating what happens in respect of the North American airlines.

PRORATING AND AIR CANADA

British Airways and others have expressed concern about the possibility that Air Canada might use its near monopoly of Canadian domestic scheduled transport, following its acquisition of Canadian International, to adjust its prorate requirements so as to have the effect of rendering uneconomic competition with it for international traffic to and from points behind international gateways. This note explains these concerns and why Air Canada's recent behaviour gives them added strength.

Air Canada is party to the Multilateral Prorate Agreement. In the latest quarterly publication of prorate provisos (March - May 2000) applicable to that agreement, Air Canada publishes many provisos. British Airways' main concern is in respect of the prorates for Canadian domestic sectors forming part of a journey between Canada and the United Kingdom. The provisos published in the latest manual for such sectors are as follows:

for First and Business Class normal fares - 100% of the base amount;

for Economy normal fares - 100% of the base amount;

for Excursion fares originating in Canada - 100% of the base amount;
for Excursion fares originating in the UK - 70% of the base amount;

for Super Apex fares originating in the UK - 70% of the base amount except in respect of travel between seven pairs of points within Canada when the amount varies between 34% (Ottawa - Toronto or v.v.) and 100% (Toronto - London Ontario or v.v.);
for Super Apex fares originating in Canada - 100% of the base amount;

for Apex fares originating in the UK - 70% of the base amount except for travel between eleven pairs of points within Canada when the amount varies between 31% (Toronto - Calgary or Edmonton or v.v.) and 100% (Toronto - London Ontario or v.v. and Vancouver - Nanaimo or Victoria or v.v.);
for Apex fares originating in Canada - 100% of the base amount;

for Pex fares originating in the UK - 70% of the base amount except in respect of travel

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Normal fares are the fully flexible fares.

The base amounts are the basic fares, the highest fare level available for sale, on the sector and in the class concerned, at the date of capture of data for the quarterly manual.

Excursion fares are relatively unrestricted fares designed typically for personal travel.

Apex fares are fares with a requirement that they be purchased more than some specified time before travel. Super Apex fares have longer purchase lead times than Apex fares and will usually be cheaper than Apex fares.

Pex fares are quite restricted fares but without any requirement that they be purchased by any particular time; that is, they can be bought any time up to the time of travel. They will generally be cheaper than Excursion fares but dearer than Apex fares.

between nine pairs of points within Canada when the amount varies between 34% (Ottawa - Toronto or v.v.) and 100% (Toronto - London Ontario or v.v.);
for Pex fares originating in Canada - 70% of the base amount; and

for other fares - 70% of the base amount.

In practice, in many cases these provisos will not apply because they would lead to the transatlantic leg's recovering less than the minimum permitted; therefore straight rate prorating will apply. For example, the prorate mileage for Toronto - London (UK) is 4299 miles and the minimum rate that an airline must receive for that sector after any proviso has been applied is US$0.088 per mile........... or US$378.31, which is about CA$560. This means that for a round trip the transatlantic airline would have to receive at least CA$1120. Air Canada's promotional fares (i.e. everything except the normal fares) for Ottawa - London in June 2000 range from CA$799 to CA$1337, return. Assuming that another airline competed with it at these fare levels but routing its passengers over Toronto, then it is clear that only at the very highest end of this range would there be any prospect of Air Canada's being able to obtain a proviso on the domestic sector without taking the transatlantic airline's take down below the minimum.

Where the provisos will tend to bite is in respect of the normal fares, particularly in business and first class. Using the same journey as an example, Air Canada's normal fares in economy, business and first class from Ottawa to London are CA$1357, CA$2250 and CA$4698, respectively, one way. This means that any prorate proviso for the Ottawa - Toronto leg which is not more than $797, $1690 or $4138 in each class, respectively would still leave the transatlantic airline with more than the minimum and would therefore be applied. These compare with Air Canada's current highest fares on the Ottawa - Toronto route of $333 and $389 in economy and business classes, respectively. If, in accordance with Air Canada's proviso, it is paid 100% of the local fare for the Ottawa - Toronto leg, a competitor which competes with it in the Ottawa - London market by matching its fares over Toronto would be left with CA$1034, CA$1861 and CA$4309 for economy, business and first classes respectively for the Toronto - London leg. These compare with Air Canada's own prices for Toronto - London as a separate journey of CA$1357, CA$2250 and CA$4781 in economy, business and first respectively.

It will be seen that, since Air Canada's fares from Ottawa to London are the same as or lower than its fares between Toronto and London, any competitor trying to compete with its direct services Ottawa - London is already at a disadvantage, in that whatever the prorate it has to pay Air Canada for the Ottawa - Toronto leg, it will end up with a discount on the point-to-point fare for Toronto - London. The proviso Air Canada publishes, applied using its current published fares for the domestic sector makes this discount substantial. But the action Air Canada took earlier this year made the discount prohibitive and would provided it with a prorate for its sector much greater than its own highest fare for the journey.

.... This is the present rate but it varies from year to year.

In the last week of March, Air Canada made changes to its domestic fares. It re-designated its existing highest, fully flexible fares in each class. Prior to the re-designation, the fares were labelled 'J' and 'Y' in business and economy, respectively. In the new structure the same fares, with identical conditions were re-designated 'J1' and 'Y1', respectively and new much higher fares, indistinguishable in conditions, were added using the old designations J and Y. These fares were available for sale and travel for about three weeks. This covered the period in which the Prorate Agency collected data for its quarterly publication. It, in accordance with its rules, would have selected these higher fares as the base amounts for the next quarter (June - August) in place of the previous amounts, now represented by the new J1 and Y1 fares. Of course these higher fares would not actually be bought by passengers, since they provided nothing that the much lower J1 and Y1 fares did not provide.

The effect of these changes on Ottawa - Toronto - London, is to raise Air Canada's prorate proviso from CA$389 for business class normal-fare passengers to CA$1143. This will leave the transatlantic airline which is matching Air Canada's fares for Ottawa - London with CA$1007, or 45% of the fare for Toronto - London on its own, while Air Canada gets 14% more, amounting to nearly three times its highest fare for the Ottawa - Toronto leg.

Appendix "B"

Draft regulations to be promulgated pursuant to Section 13 of Bill C-26 to Define Anti-competitive conduct in Air Transportation Markets

(i) alters its network or other infrastructure facilities for the purpose of or with the effect of disciplining or eliminating a competitor or otherwise substantially lessening competition in a market.

(ii) offers a discount, commission or other concession to a person or persons in respect of, or in connection with, domestic or international travel on the condition that such person or persons commit to purchase, acquire or book air transportation services for either domestic or international travel primarily from that carrier or based on an increased share of business from that carrier.

(iii) uses a frequent flyer program, loyalty program or any non-price incentive for the purpose of or with the effect of disciplining or eliminating a competitor or otherwise substantially lessening competition in a market.

Draft regulation to be promulgated pursuant to Section 13 of Bill C-26 to Define Essential Services and Facilities in Air Transportation Markets

(i) For the purposes of section 78, and in respect of air transportation markets, an essential "service" or "facility", without restricting the generality of these terms, includes: frequent flyer programs, interline services, maintenance services, baggage handling, loading and other ground services.

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