2 Conclusions

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The references

2.1. Under the reference (see Appendix 1.1) dated 2 May 2000 (made under sections 64 and 69(2) of the Fair Trading Act 1973 (the Fair Trading Act)) we are required to investigate and report upon whether a merger situation qualifying for investigation has been created in that enterprises carried on by or under the control of Air Canada (one at least of which was carried on in the UK) have within the four months preceding the date of the reference ceased to be distinct from enterprises carried on by or under the control of CAC. By an amendment to the reference dated 27 June 2000 we were also asked under section 75 of the Fair Trading Act to consider whether arrangements were in progress or in contemplation which, if carried into effect, would result in the creation of such a merger situation and whether, if events so required, the actual results of these arrangements were the creation of such a situation. Section 75(2) of the Fair Trading Act requires us to proceed in relation to the arrangements proposed or made as if they had actually been made and the results in question had followed immediately before the date of the reference.

2.2. In the case of each reference we are also required to investigate whether the creation of any merger situation we may find operates or may be expected to operate against the public interest.

2.3. One of the conditions which must be satisfied for there to be a merger situation qualifying for investigation or in progress or contemplation is that at least one of the enterprises carried on by or under the control of either Air Canada or CAC is carried on in the UK or by or under the control of a body corporate incorporated in the UK. A second is that either the value of the assets taken over exceeds £70 million (the assets test) or the merger will create or enhance a share of at least one-quarter in the supply of goods or services of any description in the UK or in a substantial part of the UK (the share of supply test). If we find that either of these tests is met, the reference requires us to exclude the other from our consideration.

The merger situations

2.4. The various actions leading to the acquisition by Air Canada of CAC are described in Chapter 3. As noted in paragraph 3.17, an offer by 853350 Alberta Ltd (853350) for CAC was declared unconditional and completed on 4 January 2000, at which date 853350 held approximately 82 per cent of CAC's shares. 853350 was a newly incorporated bidding vehicle, the shares in which at the time of the offer were held as to 10 per cent by Air Canada and 90 per cent by a Toronto businessman. The C$92 million bid by 853350 for CAC was, however, financed by Air Canada and the arrangements by which Air Canada had only a minority stake in 853350, and hence in CAC, were intended as temporary. As noted in paragraph 3.18, following the take-up of the CAC shares by 853350, CAC and its principal operating subsidiary Canadian Airlines applied to the Alberta Court of Queen's Bench in order to seek protection from their creditors and, in cooperation with Air Canada, put forward a scheme to reschedule and reduce outstanding debt and other financial obligations. The debt restructuring arrangements were approved by the Alberta Court on 27 June (although one participant in CAC's unsecured bond issue has indicated that it would seek leave to appeal), and on 5 July 2000 Air Canada acquired the shares in 853350 which it did not already own. CAC relinquished its shareholdings in Canadian Airlines for a nominal sum and 853350 became the sole owner of Canadian Airlines.

2.5. As at the date of reference to us made under sections 64 and 69(2) of the Fair Trading Act, 853350 therefore had a controlling interest in CAC, but Air Canada did not itself have a controlling interest in 853350 or CAC. However, the President and Chief Executive Officer of Air Canada was the Chairman of 853350 (as is evident in the signing of undertakings to the

Canadian Government—see Appendix 3.5). A condition of the 853350 offer was that satisfactory arrangements be made to secure the resignation and replacement of the directors of CAC, which occurred. All but one of eight members of the CAC board had been appointed on or since 4 January 2000; three of those board members were also employed by Air Canada and a fourth was a former Air Canada employee. Steps had been taken by Air Canada and Canadian Airlines to coordinate their route planning, to share their codes, and to integrate various support and other functions. The continued existence of CAC, moreover, was dependent on financial support from Air Canada. Although Air Canada did not therefore at the date of the reference to us have a controlling interest in CAC, it acknowledged to us that it was able materially to influence the policy of CAC. In our view, endorsed by nearly all the parties from whom we heard, it should be treated under section 65 of the Fair Trading Act as having had control of CAC at that time. It acquired the ability to influence the policy of CAC at the earliest on 4 January, within the four months preceding the date of the reference to us. It confirmed to us that it intended at that time to acquire a controlling interest in 853350, subject to a satisfactory outcome of the debt restructuring arrangements, and in doing so would acquire a controlling interest in CAC. As noted in paragraph 2.4, during the course of our inquiry, Air Canada did indeed complete the acquisition of shares in 853350 and hence acquire a controlling interest in CAC and Canadian Airlines.

2.6. As discussed further below, Air Canada operates a number of air services between Canada and the UK for which purpose Air Canada carries on business within the UK; hence at least one of the enterprises carried on by or under the control of Air Canada can be regarded as having been carried on in the UK. As is evident from Appendix 3.4, the gross assets of CAC exceed £70 million, hence we conclude that the assets test has been satisfied.

2.7. We conclude, therefore, that a merger situation qualifying for investigation has been created in that enterprises of Air Canada and CAC have ceased to be distinct by virtue of Air Canada having acquired control of enterprises of CAC. We also conclude that at the date of the reference made to us under section 75 of the Fair Trading Act arrangements were in progress or contemplation, namely the intention of Air Canada to acquire a controlling interest in CAC, which have been carried into effect, the actual results of which being the creation of a merger situation qualifying for investigation.

2.8. Because of the similarities of the two merger situations which we are asked to consider, our analysis in reaching our conclusions is common to both merger situations.

The parties

2.9. As noted in paragraph 3.23, Air Canada is a public company with its headquarters in Montreal, Quebec. It was first established in 1937 and was initially owned by Canadian National Railway Company, itself owned by the Canadian Government, until its ownership was transferred directly to the Government in 1977. In 1988, the minority of the shares in Air Canada were sold by the Government, with the remaining shares being sold in 1989.

2.10. Before the merger, Air Canada, including its regional airlines, had a combined fleet of some 240 aircraft operating about 1,200 daily flights, and in 1999 carried approximately 19.4 million passengers. It is a member of the Star Alliance, an alliance of airlines whose membership includes Lufthansa, United Airlines and (since 1 July 2000) British Midland Airways Limited (British Midland). Lufthansa and United Airlines have invested significantly in Air Canada. Its operating revenue in 1999 was C$6.5 billion. It had a net income before tax of C$387 million in that year. Three-quarters of its total operating revenue is from passenger transport, almost half of which relates to domestic services, 30 per cent to services to the USA and the remainder to other international services. As shown in Table 3.3, revenue on services between Canada and the UK accounted for C$[✂] million in 1999.

2.11. CAC was incorporated in 1956 as PWA Corporation (PWAC), operating a small regional airline in Western Canada called Pacific Western Airlines. Canadian Airlines was formed in 1987, following a series of mergers involving Pacific Western Airlines, Canadian Pacific Airlines, Nordair, Eastern Provincial Airways and Transair. Subsequently in 1989 Canadian Airlines acquired control of Wardair. We were told that PWAC's programme of expansion by acquisition contributed to near financial collapse in 1992, and it was rescued by AMR Corporation (AMR), the parent company of American Airlines. AMR made a significant equity investment in Canadian Airlines in 1994. In 1995, PWAC changed its name to CAC, but was again in financial difficulties in 1996, when it embarked on a four-year restructuring plan.

2.12. CAC had two main operating subsidiaries, Canadian Airlines and Canadian Regional Airlines (1998) Limited (CRAL). Canadian Airlines operated scheduled and chartered air passenger and cargo services from and within Canada. CRAL had separate networks of shorter regional services operated with smaller aircraft in Eastern and Western Canada (but with a few services between Eastern Canada and the USA). Canadian Airlines and CRAL together had 137 aircraft and carried 11.2 million passengers in 1999. Canadian Airlines was a member of the Oneworld Alliance of airlines which also includes American Airlines and British Airways Plc (BA). CAC's revenue in 1999 was about C$3.3 billion, but with a net loss before tax of C$220 million: as shown in Table 3.4, it made significant losses in four of the last five financial years. As noted in Table 3.5, almost half of CAC's operating revenues in 1999 were on domestic services, 13 per cent on US services and 36 per cent on other international services. Canadian Airlines operated services between London Heathrow and Toronto, Vancouver, Ottawa and Calgary on which it had a code-sharing agreement with BA as well as, in the case of the London–Toronto routes, a revenue-sharing agreement. Revenue on these services in 1999 amounted to about C$[✂] million, on which it earned a profit of some C$[✂] million.

Reasons for the merger

2.13. As noted in Chapter 3, CAC and its subsidiaries (the CAC group) incurred substantial losses over the last five years. By the beginning of 1999 it was clear to the management of CAC that, in the absence of a major initiative, the company would sooner or later run out of money. In January 1999, CAC initiated discussions with Air Canada concerning a possible merger of the two airlines, but no agreement was reached. In June 1999, Air Canada approached Canadian Airlines with an offer to acquire its international air routes and to enter into an extensive code-sharing arrangement with it. This offer was rejected by Canadian Airlines in August 1999, shortly before a new proposal for combining Air Canada and CAC was announced by Onex Corporation (Onex), supported by AMR. Onex launched a takeover bid for Air Canada, which was rejected by Air Canada. It was withdrawn in November 1999 following a ruling by the Quebec Superior Court that the offer violated the terms of the Air Canada Public Participation Act which prevented any one shareholder in Air Canada from holding more than 10 per cent of the company's shares.

2.14. The offer by 853350 to acquire CAC was made shortly after the withdrawal of the Onex offer. CAC told us that it investigated whether other members of the Oneworld Alliance were prepared to provide financial support, but it had been unable to prepare any business plan which demonstrated its future viability. In late November 1999, BA made an offer to acquire Canadian Airlines' operations between London and Toronto and the associated airport slots: BA intended to reduce the overall frequency of these services and to reuse some of the slots for other destinations. We were told that this offer was on the basis that Canadian Airlines would cease to fly on that route, but also assumed Canadian Airlines' continuing support in the Canadian market and obtaining the rest of the funding it needed: conditions that in practice could not be met. CAC's board recommended acceptance of 853350's offer on 4 December

1999. CAC also needed a cash injection from Air Canada at the end of December before it was acquired by 853350 in January 2000 and further financial support thereafter.

2.15. As also noted in Chapters 3 and 5, the Canadian Government told us that if CAC failed it would have caused considerable disruption in a country which is large and sparsely populated, and where some communities had become reliant on air transport. The Canadian Government saw little prospect of CAC's future viability and believed it was necessary to foster some kind of merger between CAC and Air Canada. In August 1999 it had therefore issued an order permitting the Cabinet to take any steps to deal with extraordinary disruptions to Canada's transportation system, and suspending certain provisions of the Competition Act. A policy framework document had been drawn up and published in October, outlining the Government's requirements in relation to any dominant carrier that might emerge from the discussions between Air Canada and CAC and setting up a procedure for reviewing any proposals for creating one. At about the same time the Canadian Commissioner of Competition had published a series of recommendations for enhancing competition in the Canadian airline industry, in the event of a single dominant carrier being created.

2.16. Undertakings were secured from Air Canada and 853350 by the Canadian Government and the Canadian Commissioner of Competition as a condition of the merger (see Appendix 3.5). During our inquiry, the Canadian Parliament was also in the process of passing an Act[1] which was intended to assist in enforcing these undertakings and implementing other measures relevant, in the view of the Canadian Government, to safeguarding the interests of competition and consumers. Other policies adopted by the Canadian Government include the decision to designate any Canadian airline wishing to be so designated to operate a scheduled service to large international markets, including the UK, and consequently three Canadian charter carriers have been designated to operate services to the UK as scheduled airlines. The Canadian Government also liberalized its air charter policy in April 2000, and intends further to review its international air policy generally.

Alternatives to the merger

2.17. In order to establish the effects of the merger, we have to consider the position which would have obtained, including the prospects for competition, if a merger between Air Canada and CAC had not occurred in some form or another.

2.18. As noted in paragraph 2.13, the merger followed a long period of significant losses within the CAC group, and at the time of the merger it was experiencing serious cash-flow problems. The view of the Canadian Government was that Canadian Airlines would have failed and that there was no acceptable alternative to the merger given the disruption (to passengers, to communities dependent on air transport and to employees) that a failure of Canadian Airlines would have caused within Canada. As is apparent in paragraph 2.15, and Chapters 3 and 5, the Canadian Government had a strong interest in avoiding that disruption. Having regard to the involvement and stated position of the Canadian Government, we consider that it is most unlikely that CAC would have been allowed to fail.

2.19. The Onex bid having failed, and with other partial offers having been rejected, we received no evidence of other bids for CAC. We therefore consider that an alternative bid for CAC could not be regarded as likely. Furthermore, the stated position of the Canadian Government was not to provide further financial support. The financial failure of Canadian

[1]The Act—called 'An Act to amend the Canada Transportation Act, the Competition Act, the Competition Tribunal Act and the Air Canada Public Participation Act and to amend another Act in consequence'—received Royal Assent on 29 June 2000.

Airlines and its break-up is therefore, in our view, the only meaningful scenario against which to judge the effects of the merger.

2.20. The manner in which that failure would have occurred and its consequences are highly uncertain, but could have involved the piecemeal disposal of some of Canadian Airlines' operations, the cessation of others and the immediate loss of customers to competitors able to respond both domestically and internationally, most probably Air Canada.

2.21. As far as the Canadian domestic market is concerned, Canadian law inhibits entry by non-Canadian-owned airlines. It is highly unlikely that Canadian companies, for example Canadian-owned airlines other than Air Canada, would have attempted to acquire or take on more than a limited proportion of Canadian Airlines' domestic services, given their previous losses: Air Canada was also in a stronger position than other domestic airlines to acquire some of these operations, given the scope for cost savings and other commercial benefits potentially achievable by combining the two airlines. International services would have been more attractive to other operators although the agreement between the UK and Canadian Governments prohibits entry by non-UK or non-Canadian-owned airlines on the UK–Canada services, where Canadian Airlines' profitability was modest and was largely attributed by Canadian Airlines to its code-sharing agreement with BA. Air Canada had itself previously made an unsuccessful offer for the international services, but we believe other operators would also have sought to obtain some of them. BA had, for example (as noted in paragraph 2.14), also offered unsuccessfully to acquire the Heathrow–Toronto route (although intending to reuse some of the Heathrow slots for other services). We believe that BA or an alternative operator would have sought to obtain at least a proportion of the Heathrow–Toronto and possibly the Heathrow–Vancouver services including their associated slots.

2.22. The Canadian Government took the view that the merger was preferable to such uncertainty of outcome, and a package of measures was negotiated, primarily in order to safeguard the position of other domestic airlines and domestic passengers within Canada. It is our function to determine the effect of the merger, not the effect of the consequential measures adopted by the Canadian Government. Following consideration of the market, we discuss the change in the market following the merger, before considering whether any such change can be regarded as a consequence of the merger or whether it was a change likely to happen in the absence of the merger, that is, in the event of the financial failure and break-up of Canadian Airlines.

The markets affected by the merger

Passengers on direct services between the UK and Canada

2.23. Statistics produced by the Civil Aviation Authority (CAA) show that in 1999 there were some 3.2 million journeys on direct services between the UK and Canada; ie those services flying direct between the UK and Canada, without requiring passengers to change plane. Passengers on direct services therefore include those who transfer to or from other flights, but exclude those who travel between the UK and Canada via other countries in which they change plane. Table 2.1 shows the number of passengers travelling on scheduled and charter direct services using airports in the London area and elsewhere in the UK. Direct services between the UK and Canada do not, however, necessarily constitute the market relevant in assessing the effect of the merger on the public interest. In the following paragraphs, we consider a number of different ways in which the appropriate market may be defined.

TABLE 2.1 **Passengers on direct services between the UK and Canada, 1999**

'000

	Scheduled	*Charter*	*Total*
Gatwick	-	381	381
Heathrow	2,303	1	2,304
Stansted	-	17	17
Total London airports	2,303	399	2,703
Manchester	75	166	242
Glasgow	72	109	181
Other non-London airports	-	123	123
Total non-London airports	147	398	546
Total	2,450	798	3,249

Source: CAA Airport Statistics.

Origin and destination passengers

2.24. We use the term origin and destination (OD) passengers to define passengers with reference to where they start and finish their air journeys. A significant number of passengers use connecting services from outside the UK to transfer (particularly at Heathrow) to services to Canada. As shown in Table 4.10, on average about 50 per cent of passengers on services between Heathrow and Toronto, Vancouver, Calgary and Ottawa transfer at Heathrow. These passengers transferred mainly to or from places outside the UK. There are alternative indirect routings available to most such passengers via other hub airports. That is also the case for passengers who fly to Canada and change at a Canadian airport for destinations in the USA, although, as shown in Table 4.9, the number of such passengers is relatively limited. Given that such passengers already have to, or choose to, transfer between planes and the wide choice of alternative routings available to them to transfer at other hub airports, it is correct, in our view, to distinguish passengers with origins and destinations in the UK and Canada from those with origins and/or destinations elsewhere.

2.25. UK–Canada OD passengers include those with origins and destinations in the UK and Canada who travel via airports elsewhere in Europe or the USA. These account for a relatively small proportion of traffic, but the scope for such OD passengers who currently fly on direct flights to use such indirect routings is a factor considered below.

'Time-sensitive' and 'price-sensitive' passengers

2.26. Many of the parties from whom we have heard have suggested that it is appropriate to distinguish 'time-sensitive' (primarily, but not exclusively, business) passengers from 'price-sensitive' (primarily leisure) passengers, although Air Canada argued that such a distinction was more apparent than real. Time-sensitive passengers are passengers who generally require a greater frequency of service and choice of timings, and an ability to book shortly before travelling and to transfer tickets from one flight to another in the event of changes in travel plans; many business passengers also require a more comfortable flight, for which a significantly higher fare is paid. Some leisure passengers may to an extent require some of these facilities, but a large number of leisure passengers wish to pay lower fares and are prepared to accept more restrictions on the use of their tickets, lower frequencies and less choice of departure time.

2.27. A distinction between time-sensitive and price-sensitive passengers is, therefore, in our view reasonable, in the main corresponding to a distinction between business and leisure

travel. In practice, we have used data derived from CAA surveys on the main purpose of journeys, which classify passengers as business or leisure: such business passengers include those travelling in economy as well as first and business class.

Scheduled and charter services

2.28. The distinction between time-sensitive and price-sensitive passengers is directly relevant to that between scheduled and charter services. Air Canada argued that no distinction should be made between scheduled and charter services, arguing that the charter operators competed strongly in leisure markets and, particularly with the redesignation of former Canadian charter operators as scheduled, would also compete for some business passengers.

2.29. At present, however, business passengers almost exclusively use scheduled services which offer the facilities outlined in paragraph 2.26 and business passengers provide a large proportion of revenue on these services. As we discuss further below, it is currently uncertain how effectively the former charter operators (who, as charter operators, have previously carried very few business passengers) will compete for business passengers, since their services, although now scheduled, are less frequent and use Gatwick or Stansted rather than Heathrow. Although we acknowledge that many leisure passengers regard charter and scheduled services as substitutes, we believe that for time-sensitive passengers it is appropriate to make a distinction between scheduled services and charter services (in which category we include the former charter services). We consider the implication of the redesignation of the former charter operations separately below.

Individual routes

2.30. Passengers generally want to fly from their origin to their destination, for example from London to Toronto, with what they judge to be the best combination of speed, cost, service and other relevant factors. Nonetheless, the market could be regarded as wider than a particular direct route if there was a wide choice of alternative routings available of similar convenience, and if passengers chose freely between them. Time-sensitive passengers have, however, a strong preference for direct rather than indirect flights, and many leisure passengers may also prefer direct flights to avoid both the time and uncertainty of transferring between flights. Given the advantages of direct flights, it is also in our view appropriate to regard the particular origins and destinations served and the routes between them as separate markets.

The position of Heathrow

2.31. It was also suggested to us that, within the London area airports, services from Heathrow should be regarded as a different market to services from other airports such as Gatwick or Stansted. Virgin Atlantic Airways Limited (Virgin), for example, argued (see paragraph 5.198) that far more business passengers travelled from Heathrow than the other London airports because it served a different catchment area, it was preferred by business passengers, and it had greater frequency of flights. This was disputed by British Midland as well as Air Canada who argued that Gatwick and Stansted were as accessible as Heathrow and that Gatwick in particular was developing its own network of connecting flights.

2.32. Heathrow has, in our view, significant advantages, both to airlines and at least to time-sensitive passengers, which distinguish it from Gatwick or Stansted. We noted in paragraph 2.24 that about 50 per cent of passengers on services between Heathrow and Canada transfer at Heathrow to or from other flights. Heathrow is a major hub airport, which benefits both transfer and OD passengers. Transfer passengers benefit from the high frequency of

connections available to destinations important to business passengers; that transfer traffic is also important to the profitability of services, sustaining the high frequency of those connections. The high frequency of service is also a significant benefit to OD passengers providing a greater choice of flight and alternatives in the event of changes in travel plans. The success of Heathrow as a hub thus breeds success. Some of these advantages are also valued by some leisure passengers. The advantages of Heathrow to passengers and airlines are confirmed by the higher revenue per passenger on Heathrow flights and the greater demand of airlines for slots to operate at Heathrow than at Gatwick.

2.33. We believe, therefore, that the advantages of Heathrow at least to time-sensitive passengers and to airlines are such that it is reasonable to distinguish a market for services between Heathrow and individual destinations within Canada. However, the advantages to price-sensitive passengers from using Heathrow are much less, since they generally give less weight to frequency and flexibility. As noted in our recent report on the acquisition by BA of CityFlyer,[1] it may not be reasonable to distinguish between Heathrow and Gatwick within the leisure market.

Conclusions on the relevant markets

2.34. In our view, therefore, within the overall market for air passengers between the UK and Canada it is appropriate to differentiate as relevant markets passengers with OD in the UK and Canada from those travelling behind or beyond the UK and Canada; time-sensitive as opposed to price-sensitive passengers; and, in the context of time-sensitive passengers, scheduled as opposed to charter services including the former charter services on these routes. We also believe it appropriate to differentiate as relevant markets individual routes and, for time-sensitive passengers, among the routes to and from the London area airports, between Heathrow routes on the one hand and Gatwick and Stansted routes on the other. We consider these various relevant markets further below, with the emphasis, in particular, on all passengers on direct services on individual routes, on OD passengers on those routes and on time-sensitive OD passengers on scheduled services on those routes.

Freight

2.35. Air freight is generally price-sensitive rather than time-sensitive, and alternative routings can be readily considered, including trucking of freight to other airports. The distinctions which can be drawn with regard to passengers are therefore largely inappropriate with regard to freight. We regard freight as a separate market, with its own characteristics. No concerns were expressed to us about the freight market, and we have confined our subsequent analysis to passenger markets.

Issues

2.36. In our issues statement published during the course of the inquiry (see Appendix 2.1) we set out a number of issues which we would need to consider in determining whether the merger may be expected to operate against the public interest. The alternatives to the merger and relevant markets have been discussed above; the other issues related to the effects on competition between existing airline operators, whether there are barriers to entry, and the measures adopted by the Canadian Government. These are discussed in the following paragraphs.

[1] *British Airways Plc and CityFlyer Express Limited: a report on the proposed merger*, The Stationery Office, Cm 4346, July 1999.

Competition between existing airline operators

2.37. Before the merger, Air Canada and Canadian Airlines both operated services between Heathrow and Toronto, Vancouver, Calgary and Ottawa. We refer to these as the 'overlap' services. Of those routes, BA also operated between Heathrow and Toronto and Vancouver. Additionally, Air Canada operated between Heathrow and Montreal, Edmonton, Halifax and St John's; and BA operated between Heathrow and Montreal. The number of passengers on routes between all London airports and Canada in 1999 is summarized in Table 2.2. Air Canada also operated between Manchester and Toronto and between Glasgow and Toronto.

TABLE 2.2 **Passengers between Canada and all London airports, 1999**

'000

Canadian destinations	*Passengers on direct services (scheduled and charter including transfer)*	*OD passengers*	*Scheduled business OD passengers*
Toronto	1,276	669	108
Vancouver	563	304	24
Calgary	295	152	12
Ottawa	154	107	38
Montreal	296	146	42
Edmonton/Halifax/St John's	119	101	26
Other Canadian airports	-	103	28
Total Canada	2,703	1,580	278

Source: CC study from statistics provided by CAA and Air Canada.

2.38. Table 2.3 shows the estimated market shares in 1999 of Air Canada, Canadian Airlines and BA for all passengers on direct services, for OD passengers, and for scheduled business OD passengers. These figures are based primarily on estimates by the CAA, in turn based on survey data. Market share figures based on sales data were also provided to us by Air Canada (although it believed such data might understate numbers of passengers on scheduled flights). This suggested that the market shares of airlines other than Air Canada, Canadian Airlines and BA could be somewhat higher than estimated by the CAA. However, the differences between the CAA and Air Canada data do not affect our analysis below. In order to give an indication of the position following the merger, Table 2.3 also shows the combined market share of Air Canada and Canadian Airlines based on their respective shares in 1999. Since January 2000, the number of Air Canada and Canadian Airlines services between London (Heathrow) and Toronto has been reduced from 45 to 35 a week (for the summer period) while BA Heathrow–Toronto services have increased from 11 to 14 a week. This table does not therefore allow for the effect on market share of those changes in the level of services. Neither does it allow for the redesignation of the former charter operators as scheduled services. In the case of time-sensitive passengers, we took the view that it was appropriate to look at a separate market for services from Heathrow, but since no scheduled services were operated from other London airports to Canada in 1999, the Heathrow–Canada routes were synonymous with the London–Canada routes in that year for time-sensitive passengers.

TABLE 2.3 **Estimated market shares, 1999**

per cent

	Air Canada	*Canadian Airlines*	*BA*	*Other*	*Air Canada plus Canadian Airlines*
Passengers on direct services					
UK–Canada	35	18	23	25	53
London–Canada	37	21	27	15	58
London–Toronto	31	24	24	21	55
London–Vancouver	31	10	42	17	41
London–Calgary	36	49	-	15	85
London–Ottawa	63	31		5	94
OD passengers					
UK–Canada	30	12	15	43	42
London–Canada	36	15	18	31	51
London–Toronto	26	14	16	44	40
London–Vancouver	27	9	28	36	36
London–Calgary	35	29	2	33	64
London–Ottawa	51	35	3	8	86
Scheduled business OD passengers					
London–Canada	50	22	25	4	72
London–Toronto	42	29	24	4	71
London–Vancouver	24	15	59	2	39
London–Calgary	53	47	-	-	100
London–Ottawa	60	36	4	-	96

Source: CC study from statistics provided by the CAA and Air Canada.

Note: See paragraph 4.58 for basis of estimates.

2.39. As can be seen from Table 2.3, with the merger Air Canada and Canadian Airlines would together account for 53 per cent of all passengers on direct services between the UK and Canada, which includes passengers with origins and destinations behind and beyond the UK or Canada, and 42 per cent of UK–Canada OD traffic, reflecting the large share of charter carriers particularly to and from airports outside the London area. The following paragraphs discuss the changes in market shares following the merger on the overlap services from London on the basis of the 1999 figures as set out in the previous paragraph. We consider in paragraphs 2.67 to 2.70, however, to what extent those changes in market share can be regarded as attributable to the merger.

London–Canada services

2.40. With the merger, on the basis of the 1999 figures, Air Canada would have a 58 per cent share of all passengers on London–Canada direct services, compared with 37 per cent before the merger; the next largest carrier is BA with a 27 per cent market share. Air Canada would have a 51 per cent share of London–Canada OD passengers with the merger, compared with 36 per cent before the merger. It would also have some 72 per cent market share of London–Canada scheduled business OD passengers (which we take as a reasonable indicator of time-sensitive passengers) with the merger, compared with 50 per cent before the merger.

London–Toronto

2.41. As shown in Table 2.2, London–Toronto is by some margin the largest of the London–Canada services, accounting for over 40 per cent of London–Canada passengers. Air

Canada's share of all passengers on direct services between London and Toronto would be about 55 per cent with the merger, compared with 31 per cent before the merger. It would account for some 40 per cent of OD passengers (compared with 26 per cent before the merger), primarily reflecting the importance of charter services on this route; but 71 per cent of scheduled business OD passengers (compared with 42 per cent before the merger).

London–Vancouver

2.42. London–Vancouver is the second largest London–Canada service. Air Canada's share of all passengers on London–Vancouver direct services would be some 41 per cent with the merger (compared with 31 per cent before the merger), with 36 per cent of OD passengers (compared with 27 per cent before the merger) and 39 per cent of scheduled business OD passengers (compared with 24 per cent before the merger).

London–Calgary

2.43. Air Canada would have a market share on the London–Calgary route following the merger of some 85 per cent of all passengers on direct services (compared with 36 per cent before the merger), some 64 per cent of OD passengers (compared with 35 per cent before the merger) and all scheduled business OD traffic (compared with 53 per cent before the merger). As is apparent from Table 2.2, however, the London–Calgary route carried only about 150,000 OD passengers in 1999 (less than 10 per cent of London–Canada OD passengers) and only some 12,000 scheduled business OD passengers (about 4 per cent of London–Canada scheduled business OD passengers).

London–Ottawa

2.44. Air Canada would have a market share on the London–Ottawa route following the merger of about 94 per cent of passengers on direct services (compared with 63 per cent before the merger), about 86 per cent of OD and some 96 per cent of business scheduled OD traffic (compared with 51 per cent and 60 per cent respectively before the merger). As is apparent from Table 2.2, the London–Ottawa route carried only about 100,000 OD passengers in 1999 (about 7 per cent of London–Canada OD passengers), and 38,000 scheduled business OD passengers (14 per cent of London–Canada scheduled business OD passengers).

Transfer passengers

2.45. The figures for OD passengers on each route in Table 2.2 exclude passengers who transfer at Canadian airports to internal Canadian flights to complete their journeys. The CAA's estimates of the number of passengers transferring planes at Toronto, Vancouver and Calgary are summarized in Table 4.8. For example, some 80,000 UK–Canada OD passengers transferred at Toronto for other Canadian destinations, and a further 50,000 transferred to internal Canadian flights at Vancouver or Calgary. Before the merger, connections within Canada were offered by both Air Canada and Canadian Airlines; after the merger, few connections are available other than with Air Canada: a point to which we return below.

2.46. On the other hand, Air Canada and other parties such as British Midland drew our attention to the wide range of alternative indirect routings, including, for example, connections via the USA available with members of the Oneworld Alliance. The small share (below 10 per

cent) of London–Canada traffic accounted for by indirect flights suggests to us that there are significant disadvantages in using connections via the USA or Europe. We do not see the availability of indirect flights as significantly constraining any market power of the operators of direct services in relation to time-sensitive passengers on these routes.

The relevance of the Canadian Airlines/BA code-share agreement to competition in these markets

2.47. Before the merger, BA and Canadian Airlines operated a code-share agreement on the UK–Canada services which involved considerable coordination and cross-selling on each other's services. In addition, BA and Canadian Airlines agreed to share revenues on the London–Toronto service. Both BA and Canadian Airlines acknowledged that, given these arrangements, they could not be regarded as being in competition before the merger. Canadian Airlines, indeed, told us that its UK–Canada services had not been profitable before the code-sharing agreement and regarded that agreement as a main factor in its subsequent ability to operate the services profitably.

2.48. Although there may have been some potential for competition between BA and Canadian Airlines, we find it difficult, given the existence of the code-sharing agreement, and the revenue-sharing arrangement on the Heathrow–Toronto services, to regard the number of main competitors on services between the UK and Canada as having been reduced from three to two following the merger; instead of Canadian Airlines' share of the market being closely associated with BA, it has been transferred to Air Canada. Most of the markets, on this basis, were already highly concentrated before the merger, and the changes in market shares following the merger would therefore be less significant than suggested in paragraphs 2.40 to 2.44. Nonetheless, as shown in Table 2.4, and discussed in the following paragraphs, the degree of concentration on most routes has increased, with an increase in the market share accounted for by the leading supplier, although the identity of that supplier has in several cases changed.

2.49. Table 2.4 compares the combined market share of Air Canada and Canadian Airlines with those, before the merger, of BA and Canadian Airlines combined. The figures in Table 2.4 are calculated on the same basis as those in Table 2.3, explained in paragraph 2.38.

2.50. We also show in Table 2.4 the Herfindahl Hirschman index (HHI) for each market. This index was quoted to us by the CAA and other third parties (see Chapter 5), and is a widely recognized measure of concentration, calculated by summing the squared percentage market share of each firm in the market (a monopolist's HHI being 10,000). The lower the number of firms in the market, and the more unequal their market shares, the higher the index. In merger inquiries, the US Department of Justice regards markets with an HHI of less than 1,000 as having a low level of concentration, and those with over 1,800 as having a high level of concentration. High market shares do not always confer high market power, and such an index of market shares has to be considered along with other factors likely to affect behaviour, such as the contestability of the market or whether potential competition is limited by barriers to entry. Particularly in the case of duopoly markets, the degree of effective competition may not relate directly to any such index of concentration.

TABLE 2.4 **Estimated market shares, 1999**

	Before merger			*With merger*			
	Air Canada %	*BA plus Canadian Airlines %*	*HHI*	*Air Canada plus Canadian Airlines %*	*BA %*	*HHI*	*Change in HHI*
Passengers on direct services							
UK–Canada	35	41	3,120	53	23	3,550	430
London–Canada	37	48	3,750	58	27	4,170	420
London–Toronto	31	48	3,440	55	24	3,770	330
London–Vancouver	31	52	3,770	41	42	3,500	–220
London–Calgary	36	49	3,760	85	-	7,280	3,520
London–Ottawa	63	31	4,950	94	-	8,860	3,910
OD passengers							
UK–Canada	30	27	2,100	42	15	2,460	360
London–Canada	36	33	2,590	51	18	3,090	500
London–Toronto	26	30	2,160	40	16	2,440	280
London–Vancouver	27	37	2,520	36	28	2,500	–20
London–Calgary	35	31	2,490	64	2	4,410	1,920
London–Ottawa	51	38	4,110	86	3	7,470	3,360
Scheduled business OD passengers							
London–Canada	50	47	4,720	72	25	5,820	1,100
London–Toronto	42	53	4,590	71	24	5,630	1,040
London–Vancouver	24	74	6,060	39	59	5,010	–1,050
London–Calgary	53	47	5,020	100	-	10,000	4,980
London–Ottawa	60	40	5,200	96	4	9,230	4,030

Source: CAA.

Note: See paragraph 4.58 for basis of estimates.

London–Canada services

2.51. As regards the shares of passengers on direct services between London and Canada as a whole, Air Canada would have a market share of 58 per cent and BA 27 per cent compared with Air Canada's share of 37 per cent and the combined share of Canadian Airlines and BA of 48 per cent before the merger. Although, on this basis, there has been no reduction in the number of independent competitors, whereas they were previously of equivalent scale, Air Canada would now have a significantly larger market share than that of BA and Canadian Airlines combined before the merger: hence there has been an increase in concentration on these routes. Following the merger the HHI has increased for passengers on London–Canada direct services as a whole from 3,750 to 4,170. An increase in concentration has also occurred in London–Canada OD and, to a greater extent, London–Canada scheduled business OD passengers.

London–Toronto

2.52. On the London–Toronto route, Air Canada would have 55 per cent of passengers on direct services, and BA 24 per cent. This compares with Air Canada's previous share of 31 per cent and the combined share of Canadian Airlines and BA of 48 per cent: a change in the identity of the market leader, but a more limited increase in concentration than for London–

Canada routes as a whole. Air Canada would have a share of London–Toronto OD passengers of 40 per cent and BA 16 per cent, compared with shares of 26 per cent and (for BA and Canadian Airlines combined) 30 per cent before the merger. (As noted in paragraph 2.38, the figures for shares of passengers in Table 2.2 take no account of the effects of the reduction in services by Air Canada since the merger, the introduction of additional services by BA to Toronto nor the redesignation of the former charter operators from Gatwick and Stansted as scheduled operators.) The shares of scheduled business OD traffic are higher: some 71 per cent for Air Canada with the merger compared with 53 per cent for BA and Canadian Airlines combined before the merger. Hence while there has been no reduction in the number of independent competitors on the routes, concentration particularly of scheduled business OD passengers has increased with the merger.

London–Vancouver

2.53. On the London–Vancouver route, on the other hand, Air Canada would have a share of 41 per cent of passengers on direct services with the merger and BA 42 per cent. This compares with Air Canada's share of 31 per cent prior to the merger and a combined Canadian Airlines and BA share of 52 per cent before the merger: a reduction in concentration on this route. There has also been a reduction in concentration in shares of scheduled business OD passengers on this route, but no effect on concentration in shares of OD passengers as a whole.

London–Calgary

2.54. Following the merger, competition has been eliminated for scheduled business OD passengers on the London–Calgary route, whereas the market was previously fairly even divided between Air Canada and Canadian Airlines. There are several other operators between London and Calgary, in particular the redesignated former charter operators, accounting for about 15 per cent of all passengers on direct services, but about 30 per cent of London–Calgary OD passengers.

London–Ottawa

2.55. Following the merger, Air Canada accounts for about 86 per cent of all OD passengers on the London–Ottawa route and competition has been largely eliminated for scheduled business OD passengers.

Other aspects of competition

2.56. It was argued to us that the competitive position of other airlines would be further affected as a result of Air Canada's practices as the dominant operator (as it has been described by many parties from whom we heard and also by the Canadian Competition Bureau) of domestic services within Canada. The main areas of concern were Air Canada's prorate arrangements for interline passengers, its frequent flyer programme (FFP) and its structure of commission payments.

Prorate arrangements

2.57. The background to prorate arrangements is summarized in paragraphs 4.92 to 4.94 and 4.98 to 4.101. Because the through fare charged for a journey involving two or more carriers is normally less than the fares which would be charged for the component flights on the sections involved, participating airlines must agree how the fare should be apportioned between

them. Where there is no bilateral agreement between the two airlines, there is a basic convention among the members of the International Air Transport Association (IATA) under which interlining fares are set, the multilateral prorate agreement (MPA). The principal method used in this agreement is known as straight rate prorating (SRP), which allocates the basic fare according to distance, weighted to reflect fixed costs. Airlines are, however, allowed to file 'provisos' referring to minima they are willing to receive for their leg of the passenger's journey. If such provisos leave another participating airline with less than an amount prescribed by the MPA for their share of the journey, the provisos are dropped and the fare apportioned according to the SRP.

2.58. Before the merger, BA and Canadian Airlines had a prorate arrangement as part of their code-sharing agreement. This agreement has been terminated, and Air Canada and Canadian Airlines have published, solely for the purpose of establishing the prorates, a fare higher than the normal fare. There is nothing in the MPA to prevent such an approach, but this resulted in a significant increase in the prorates. As shown in Table 4.18, for example, the business class prorates increased from C$1,420 between Toronto and Calgary to C$4,161; and from C$389 to C$1,143 between Toronto and Ottawa. The previous fares were retained (but redesignated by a different code) for passengers buying tickets between these points.

2.59. Air Canada and British Midland told us that BA also charged, under IATA arrangements, prorates higher than normal published fares on a number of routes from Heathrow which were only operated by BA. BA told us that this resulted only from the application of SRP, and BA did not file any provisos with such an effect: the prorates are significantly less on UK domestic routes of similar length than on the Toronto–Ottawa route. Air Canada argued that the policy had nothing to do with the merger, but it was the common practice of airlines in the USA to adopt a special fare for prorate purposes. This was in part accepted by BA, although it believed that the differentials between the prorate fares and the normal fares were less in the USA than now imposed by Air Canada. BA also argued that the prorates of US carriers had little effect since there was significant competition between carriers to enable BA to negotiate reasonable arrangements. Air Canada also argued, as did the Canadian Government, that the amount of BA's transfer traffic at risk from such a policy was only limited, and unlikely significantly to affect BA's ability to compete on these routes.

2.60. In our view, the ability dramatically to increase prorate fares to a level significantly in excess of normal published fares reflects the lack of competition in the Canadian market following the merger. This contrasts with the situation at the London airports, where a wider choice of airlines is generally available for interlining purposes, including airlines which are members of the main alliances. However, as is apparent from Table 4.9, only about 7 per cent of BA's passengers connect at the main Canadian airports for other Canadian destinations and we do not consider that material damage to BA's operations is likely to have been caused. Moreover, despite the more competitive environment of the London airports compared with airports in Canada, BA has itself a strong negotiating position arising from the range of connections served from Heathrow and the frequency of its connecting services there.

2.61. On the other hand, the effects of Air Canada's and Canadian Airlines' prorate charges go wider than the effects on BA alone. Some 12 per cent of all passengers on UK–Canada services connect at the Canadian gateway airports for other Canadian destinations. Even though the majority of those transfer passengers do not fly between the UK and Canada on BA flights, the extent of competition would affect fares paid. Competition to offer through fares for such passengers, including the transatlantic stage of their services, would be eliminated if BA (or any other carrier) was unable to compete to provide such indirect routings, although there would come a point at which some passengers or their agents would buy tickets on connecting flights separately, less convenient though this is. There are also alternative indirect routings to many of the ultimate destinations, although as shown in Table 4.8 a large majority of indirect passengers to Canadian destinations beyond Toronto, Vancouver and Montreal (the gateways currently served by BA) currently choose to transfer via Canadian airports, showing the

passengers' preference to travel to those destinations via a gateway in Canada as opposed to a gateway in the USA.

2.62. We have noted, however, that Air Canada's ability to increase prorates arises from the loss of competition on domestic services within Canada. In the view of the Canadian Government, which we accept, the position of Canadian Airlines and its contribution to domestic competition within Canada were unsustainable in their previous forms and Air Canada would therefore have been in a similar market position on most domestic routes irrespective of the merger—a point also accepted by BA. Hence, under the alternative scenario we discussed in paragraph 2.19, in which Canadian Airlines would have failed, competition to Air Canada would have been similarly eliminated, and Air Canada would have been in the same position to increase prorates and would, in our view, ultimately still have done so. It is therefore not possible, in our view, to regard the loss of competition which has occurred as an effect of the merger. Similarly, although Air Canada's actions in increasing prorates is likely adversely to affect competition, we do not regard it as an effect of the merger.

Commission overrides

2.63. The commission override structure introduced by Air Canada since the merger is summarized in paragraph 4.132. It provides for stepped rates of commission for Canada-based travel agents on international ticket sales, of up to [✄] per cent, the better their performance. However, it also provides for increased rates of commission on domestic sales, of up to [✄] per cent, the better the performance on sales of international tickets. Air Canada argued that this commission structure was partly in response to the undertakings sought by and agreed with the Commissioner of Competition, that the commission rates on domestic ticket sales should not increase in line with sales or market share of domestic tickets. As can be seen from paragraph 6*(a)* of the undertakings at Appendix 3.5, the undertakings provide that the trigger mechanism for travel agents who qualify for incentive override commission shall be based solely on international route revenues, explicitly permitting such a linkage, although there is nothing in the undertakings that requires a stepped rate of commission on international sales.

2.64. In our view, the commission structure adopted by Air Canada is likely to encourage the promotion and sale within Canada of Air Canada's international tickets rather than those of its competitors, or require its competitors to offer even higher rates to compete. However, we believe that Air Canada would have been in a position to operate such a commission structure, had it chosen to do so, irrespective of the merger. As a result of Canadian Airlines ceasing to compete, the intervention by the Canadian Government required Air Canada to change its previous structure of commission payments on sale of domestic tickets, to safeguard the position of other domestic operators. It now has a stepped structure of commission on international tickets and links international sales and the commission on domestic sales. However, the financial failure of Canadian Airlines and its break-up and the intervention of the Canadian Government would have occurred in the absence of this merger: hence we regard the concerns raised with us on commission overrides as resulting from the inability of Canadian Airlines to sustain competition in the domestic market and not attributable to the merger itself.

Frequent Flyer Programmes

2.65. Concern was also raised with us particularly by BA about the effects of Air Canada's FFP following the merger. Following the merger, the FFP of Air Canada is currently operating on a reciprocal basis with that of Canadian Airlines and they are to be merged with a combined membership of over 5 million. BA's equivalent scheme has in contrast some 50,000 members within Canada. Before the merger, members of BA's scheme were able to earn and redeem frequent flyer points on the international and domestic services of Canadian Airlines as a member of the Oneworld Alliance; following the merger, the points earned on BA's scheme

cannot now be used on services within Canada. The CAA, however, was relatively unconcerned about the effect of FFPs in this case, Air Canada and BA both being strong in their own domestic markets.

2.66. We believe that BA itself has significant market strength, including that of its own very strong FFP given BA's extensive network, on which points can be both earned and redeemed. Even within Canada, its scheme will benefit from the alliance with American Airlines which allows the earning and redemption of frequent flyer points on US–Canada travel. However, this issue also arises from the inability of Canadian Airlines to sustain competition within Canada, and to provide BA with a means by which points on its FFP could be earned or redeemed within Canada. Measures to encourage other competitors within Canada may have enhanced the competitive advantage of the Air Canada scheme, since points on its scheme can now be both earned and redeemed on other Canadian airlines, but we do not believe that the disadvantages to BA or other airlines arising from the scheme can be regarded as effects of the merger in itself.

Assessment of the effect on competition between existing operators

2.67. As shown in paragraphs 2.51 to 2.55, there has been an increase in concentration on some services between the UK and Canada, even after allowing for the effect of the code-sharing agreement between BA and Canadian Airlines. There has been a relatively limited increase in concentration for OD passengers on the London–Toronto route, but a more significant increase for scheduled business OD passengers on that route. The market shares of Air Canada have increased most significantly on routes to Calgary and Ottawa; the market shares for scheduled business OD traffic have increased even more on these routes than for other categories of passenger. Competition has also been significantly reduced for passengers transferring at the main gateways to other Canadian destinations.

2.68. In the absence of the merger, it is likely in our view that operators other than Air Canada might have sought to develop services between London and Toronto. We noted in paragraph 2.21 the possibility that some of the activities of Canadian Airlines could, in the absence of the merger, have been acquired by a third operator, who could have acted independently of both BA and Air Canada. Given, inter alia, the benefits that had accrued to both Canadian Airlines and BA from their previous arrangements, we consider there is no justification for basing our expectations about the effects of the merger on an assumption that, in the absence of the merger, a more competitive situation could have resulted from the failure of Canadian Airlines than actually existed when Canadian Airlines remained in operation. Nevertheless, the merger could be regarded as increasing concentration on that route.

2.69. We note that on both the London–Calgary and London–Ottawa routes, competition before the merger for scheduled business OD passengers was largely confined to that between Air Canada and Canadian Airlines (although with BA code-sharing with Canadian Airlines from 1996 to 1999). In the event of the failure of Canadian Airlines, we believe it unlikely that competition for such passengers could have been sustained on these relatively minor routes: for example, as we discuss further below, the opportunity cost of the Heathrow slots would favour alternative usage for those slots if they were to become available to another airline. Similarly, as noted in paragraph 2.21, we believe the loss of competition on Canadian domestic services would have occurred as a result of the failure of Canadian Airlines and irrespective of this merger.

2.70. We have also considered in paragraphs 2.56 to 2.66 the effects of Air Canada's practices toward prorates, commission payments and FFPs. Although we accept that these practices, in particular those in relation to prorates and commission payments, are likely to impose some disadvantage on Air Canada's competitors, we believe they result from the failure of Canadian Airlines and cannot be attributed to the merger.

Barriers to entry or expansion

2.71. In order to consider whether Air Canada is in a position following the merger to exert influence on the level of fares or service on any of these routes, we have also to consider whether the prospect for entry or expansion would limit the ability of Air Canada to act in this way or whether there are barriers to such entry or expansion. For this purpose, we include as possible entrants the three former Canadian charter carriers who have recently been redesignated as scheduled operators to the UK.

2.72. Air Canada's advantages in competing with entrants include its established frequency of services and the range of connecting flights, particularly within Canada. These factors are likely to be particularly significant in competing for time-sensitive passengers, but nonetheless some airlines (such as Virgin and British Midland) have expressed an interest in entering this market. We have noted the limited extent of the fifth and sixth freedom operators (see Appendix 4.1) on these routes and found no evidence to suggest that other such operators presently wish to enter or existing operators to expand their services on these routes. Some concern was expressed to us about the risk of anti-competitive response to new entry: but competition legislation in Canada, the EC and the UK includes provisions intended to safeguard entrants against anti-competitive practices. The main areas of concern raised with us related to regulatory barriers to entry, and the availability of slots.

Regulatory restrictions

2.73. We summarize the bilateral agreement between the UK and Canada in paragraph 4.3ff. The agreement restricts entry on UK–Canada routes to airlines owned and controlled by the Canadian or UK Governments or by Canadian or UK nationals (other than fifth or sixth freedom operators), but unlike some other bilateral agreements for air services, there is no restriction on the number of such airlines either country can designate to operate on these routes, nor on the level or frequency of service. The Canadian Government told us that it had previously been inhibited by the weakness of Canadian Airlines from further liberalizing the market and cited its recent decision, to designate three Canadian former charter operators to the UK as scheduled, as indicative of its future intentions. Although there is provision for fare regulation, we were told that this was rarely invoked by either government. While, therefore, the bilateral agreement does not significantly inhibit entry from other Canadian or UK carriers, restrictions on the nationality of ownership of the airlines that can be designated limit potential entry.

2.74. Charter services are already significant in competing for price-sensitive passengers, accounting for some 25 per cent of the London–Canada OD market and over one-third of the London–Toronto OD market. We were told that use of charter airlines was particularly popular among Canadians. Air Canada argued that, as a result of the redesignation of three Canadian charter operators as scheduled airlines, the market was now more competitive than before the merger with five operators of scheduled services on the London–Canada routes, compared with two (Air Canada versus the combination of BA and Canadian Airlines as participants in the code-share and revenue-sharing arrangements) before the merger. Other operators to whom we spoke were more sceptical about the ability of the former charter carriers to compete in scheduled markets, particularly for business traffic.

2.75. The former charter operators are, in our view, in a strong position to compete for price-sensitive passengers. However, we share the view put to us that it is too soon to judge whether the former charter operators will provide effective competition for time-sensitive traffic, given the more limited frequency of their operation, and their operation from Gatwick or Stansted rather than Heathrow. It is also uncertain how effectively they will be able to provide business class facilities to a standard high enough to compete with Air Canada and BA.

Availability of slots

2.76. Several of the parties from whom we heard argued that the main constraint on new entry was the availability of suitable slots, particularly at Heathrow. Airport Co-ordination Ltd (ACL), which is responsible for slot allocation at Heathrow, told us that 99 per cent of slots at Heathrow were utilized in summer 2000 and that all slots at peak periods, which are also the most suitable times for transatlantic operations, were used. Canadian Airlines obtained a significant number of slots after entering Heathrow in 1994: a number of parties suggested to us, however, that it had become significantly more difficult to obtain slots since 1994. If slots become available, the EC slot regulation (see paragraph 4.31ff) gives preference to new entrants (which for these purposes include airlines operating only on a very limited scale at Heathrow), but none to other existing operators at Heathrow wishing to begin to operate new services. Although a number of new entrants have acquired slots at Heathrow since 1994 under the EC slot regulation, their operations have generally been on a limited scale, of lower frequency and mostly at off-peak times less suitable for transatlantic services.

2.77. ACL told us that the most constrained periods were morning arrivals and mid to late morning departures, the ideal times for services for points in Eastern North America such as Toronto. The probability of obtaining slots at traditional transatlantic timings was therefore low. More slots were available for a daylight crossing service for arrival at Heathrow at around 2100 and departures around 0700, but such services were less attractive from an airline's point of view as it is not possible to operate an outward and return service on the same day with the same aircraft, resulting in low aircraft utilization. We noted that Virgin had applied for a number of slots to operate to Toronto but had been able to obtain only a late evening departure and midday arrival time, which it subsequently utilized for other services.

2.78. Overall, we received a range of views on the extent to which slot availability was a barrier to entry on these services. The CAA said that although it was not impossible to obtain slots at peak times, it was clearly very difficult; Air Canada agreed that it was difficult to obtain slots, but suggested that they could be obtained to operate at times which, although not preferred, could be used for transatlantic services, such as late evening departures. Virgin argued that it would not be possible economically to initiate a service on the basis of such timings, although services at off-peak times could be operated as supplementary services to those in peak times.

2.79. Air Canada also pointed out that, together with Canadian Airlines, it had returned 35 weekly slots to the pool prior to the start of the summer 2000 season (although it had also been allocated two new slots); of the 35 weekly slots, 14 had been exchanged with other airlines in the Star Alliance (some being used by Air New Zealand to establish a more regular schedule), and the slots received by Air Canada and Canadian Airlines in exchange were returned to the pool. Although the slots returned were at similar times of day to those previously operated, they are less regular and therefore potentially less convenient for operating competing services. Moreover, having been returned to the pool, these slots are being used for services to destinations other than Canada.

2.80. It is in our view difficult to regard the lack of slots available at Heathrow as a significant barrier to BA, which has already increased Heathrow–Toronto services since the merger, or to British Midland which is licensed to operate to three destinations in Canada and has a portfolio of other slots at Heathrow (including some recently traded with Air Canada). We acknowledge that both BA and British Midland would have difficulty in expanding the total number of services they operate at Heathrow: hence both would have to consider the opportunity cost of using slots for services to Canada rather than elsewhere. Given the greater scale of their operations at Heathrow, however, they have much greater flexibility than other operators in exchanging slots, or changing their use between different services, or, in the case of BA, to transfer to Gatwick, where it has an established operation, some services less dependent on connecting traffic. There is a more significant opportunity cost for airlines such

as Virgin, with a more limited portfolio, in switching slots to operate services to Toronto, although this needs to be seen in the context that Virgin, for its commercial reasons, has recently chosen to commence operations from Heathrow to Chicago and Delhi, suggesting that services to Canada were of lower priority. Although the EC slot regulation gives preference to new entrants, the prospect of slots being available at the right time is limited.

2.81. In our view, the difficulty in obtaining slots is unlikely to be as significant for operators wishing to compete for price-sensitive, rather than time-sensitive, passengers and prepared to operate at Gatwick or Stansted.

2.82. The Canadian Government and the Air Traffic Management of the Greater Toronto Airports Authority both told us that there is no difficulty in obtaining slots for transatlantic services at Toronto Pearson in view of the preference given to international flights and larger aircraft.

Prorates, commission overrides and FFPs

2.83. Concerns were also raised with us that Air Canada's prorate arrangements, commission overrides and FFPs had increased barriers to entry to the market, similar to the effects on existing operators which we discussed above. In our view, the prorate arrangements of Air Canada and Canadian Airlines are likely to make it more difficult particularly for new UK entrants to access the markets beyond the gateways. Their commission override system is also likely to make it more difficult for new UK entrants to market their services in Canada. The Air Canada FFP may also make it more difficult for other UK operators to compete, but to a much lesser extent. These three issues, however, are likely to have less impact on entry or expansion by other Canadian operators, particularly those who operate domestic services within Canada. We are not convinced that these factors are in themselves sufficient to undermine the prospects for entry on the London–Canada routes.

Assessment of barriers to entry or expansion

2.84. We accept that there are difficulties in entering particular sectors of the markets we are considering. The redesignation of the Canadian charter carriers may be expected to assist competition in the price-sensitive market, where charter operators already compete to some effect. The ability of those former charter operators effectively to compete for time-sensitive traffic is, however, more uncertain. Access to Gatwick or Stansted for new entrants wishing to compete primarily for price-sensitive passengers is also likely to be considerably easier than at Heathrow. Competition for time-sensitive passengers is currently solely based at Heathrow, where we accept that there are likely to be difficulties for entrants to Heathrow, or existing operators with a relatively limited number of slots, such as Virgin, in acquiring the appropriate slots for operations between Heathrow and Canada.

2.85. On the other hand, we do not believe BA would be constrained in expanding its operations between Heathrow and Canada if it saw competitive advantage in doing so taking into account the opportunity cost of the slots involved. British Midland also has scope to enter the market, and was unconcerned about the need to acquire slots to do so (although, as a member of Star Alliance, its degree of competition with Air Canada is likely to remain muted).

2.86. BA has already since the merger increased services to Toronto from 11 to 14 a week. In our view BA's continued ability to compete in this market and its potential further to increase its market share limits the effect of the increase in concentration in both the time-sensitive and price-sensitive sectors of the market on the London–Toronto route which we identified in paragraph 2.52. Before the merger, competition on that route was already effectively limited to that between Air Canada and the combination of BA and Canadian

Airlines as participants in the code-share and revenue-sharing agreements between them. Entry by one or more operators on the Heathrow–Toronto route would, in principle, be in the interest of passengers, but the merger has not in itself given rise to adverse effects requiring such entry.

2.87. On those routes where following the merger there is now a virtual monopoly by Air Canada, we see few barriers to entry in services to price-sensitive passengers. We noted that on both London–Calgary and London–Ottawa routes previous competition for time-sensitive passengers on scheduled services was largely confined to that between Air Canada and Canadian Airlines, albeit that Canadian Airlines were supported since 1996 by the code-share agreement with BA. The prospects for entry on these routes in services for time-sensitive passengers are likely to remain poor given the numbers of OD scheduled business passengers on those services and the opportunity cost of the Heathrow slots which would favour using the slots on other routes (not necessarily to Canada). Neither BA, British Midland nor Virgin expressed any interest in starting services on these routes. We believe that the loss of competition on these services is attributable to the inability of Canadian Airlines to sustain competition with Air Canada, and is not an effect of the merger in itself.

2.88. Air Canada's approach toward prorates for connecting flights beyond the Canadian gateways, its system of commission override payments to agents and (to a much less significant extent) its FFPs are also likely to reduce the ability particularly of new UK entrants to compete for time-sensitive traffic originating in Canada, but these are not barriers which arise as a result of the merger, and these factors are not in our view sufficient to preclude such entry.

The measures adopted by the Canadian Government

2.89. Paragraph 2.16 referred to the undertakings given by Air Canada and 853350 to the Canadian Government, and to the legislative measures concerning their enforcement. Those undertakings are set out in Appendix 3.5, and are also summarized in paragraph 3.56. They cover use of airports; transfer of surplus aircraft; the commission overrides used for domestic services; the availability of FFPs to other Canadian operators; interlining and joint fare agreements between Air Canada and other Canadian carriers; delay to the establishment by Air Canada of any discount airline in Eastern Canada; and divestiture of CRAL. The Canadian Government argued to us that such measures would allow the entry of new domestic operators, and the expansion of existing competitors within Canada, and referred to a number of cases of such entry and expansion.

2.90. The focus of the undertakings is on the provision of domestic services within Canada. They do not directly address the issue of any loss of competition on transatlantic routes or routes to or from the UK. We have also noted in paragraphs 4.125 to 4.135 that the undertakings finally agreed fall short in some respects of earlier proposals by the Competition Bureau to deal with the potential emergence of a dominant Canadian carrier.

2.91. The Canadian Government and Air Canada argued that other international carriers would benefit indirectly from measures to encourage competition within Canada, for example by the development of domestic airlines able to offer alternative prorate arrangements. Some of the airlines to which we spoke were sceptical that the undertakings would result in competition developing in Canada on any significant scale. They cited, for example, the previous failure of new entrants within Canada, but such new entry was at a time when Canadian Airlines was also operating in the market, and the prospects for entry may now be improved. However, it was also argued to us that some of the new entrants were likely to operate from different airports (such as Hamilton, near Toronto), hence their services would not assist international operators in making interline arrangements at the main international gateway airports. Airlines may also be reluctant to make arrangements to transfer their passengers other than with established carriers.

2.92. The undertakings also include an agreement to offer for sale CRAL, as a step in promoting competition in the domestic market (and supplying other potential interlining partners than Air Canada). However, CRAL's peak slots at Toronto will not be transferred along with the ownership of CRAL, but will stay with Air Canada. This reinforces the suggestion to us that regional or domestic carriers will operate more from non-gateway airports, as well as decreasing the likelihood that CRAL will be sold at all in the limited time frame allowed. We noted that most of the main Canadian airports were excluded from the undertakings concerning the waiving of majority-in-interest rights and change in the use of the Chicago formula for airport charges (see paragraph 4.129).

2.93. The Canadian Government told us that it was partly to meet the concerns of international airlines that it included provision in the proposed legislation that it would be an anti-competitive act for a person operating a domestic service to deny access on reasonable commercial terms to facilities or services that were essential to the operation of an air service, or to refuse to supply such facilities or services on such terms. Regulations are to be introduced to identify the characteristics of essential services. It was proposed that essential services would be those which are required in order to provide a competitive air service; which cannot reasonably or practically be purchased, acquired, provided or replicated by another carrier on its own behalf; which are effectively controlled by the carrier refusing to supply access; and for which it cannot be demonstrated by the carrier refusing supply that concurrent use is impractical or cannot be reasonably accommodated. They may include but are not limited to take-off and landing slots, interline arrangements, and various airport and maintenance facilities and activities. Although these provisions were broadly welcomed by, for example, BA, there was concern that any action under them could prove time-consuming and uncertain. The Canadian Government told us that, if such measures proved insufficient, it would consider further measures.

2.94. We do not believe that the measures taken to date will sufficiently address the loss of competition that has occurred on the international services with which we are most concerned. However, for the reasons set out in paragraphs 2.67 to 2.70, that loss of competition other than on the Toronto–Heathrow services cannot, in our view, be attributed to the merger we are considering. It should, however, be a matter to inform the UK Government with regard to the existing air services agreement (ASA) with the Canadian Government, and in any future renegotiations of such agreement. We note that among the principles of the UK–Canada ASA are that there should be fair and equal opportunity for the airlines of both countries to operate the services, and that each party to the agreement shall take all appropriate action within its jurisdiction to eliminate or prevent all forms of discrimination or unfair competitive practices adversely affecting the competitive position of the designated airlines of the other party.

Conclusion

The competitive situation following the merger

2.95. We have found that, following the merger, concentration has increased on a number of routes previously operated by Air Canada and Canadian Airlines, to varying extents.

2.96. On the London–Toronto route, Air Canada and Canadian Airlines would now have a joint share of total OD passengers of 40 per cent. This represents a limited increase in concentration since before the merger when BA and Canadian Airlines combined had a joint share of total OD passengers of 30 per cent. However, in the case of price-sensitive passengers, we believe there is effective competition from the former charter operators now redesignated as scheduled airlines, and from the remaining (UK) charter operators. There is also the prospect of entry or expansion, either from BA or from other operators using Heathrow or other London airports where pressure on slots is less.

2.97. As regards time-sensitive passengers, Air Canada and Canadian Airlines would now have a share of scheduled business OD passengers between Heathrow and Toronto of 71 per cent compared with the combined share of BA and Canadian Airlines of 53 per cent before the merger. There is significantly less competition from other operators for time-sensitive passengers, and more difficulty for new entrants to acquire slots at Heathrow, the advantages of Heathrow being of much greater significance for such passengers compared with price-sensitive passengers. However, we believe there are few constraints on BA expanding its services on this route, and that BA, possibly together with other operators at Heathrow, is able to provide effective competition as regards time-sensitive passengers, if Air Canada abuses its position. Competition was limited before the merger, given the code-share and revenue-sharing agreements between BA and Canadian Airlines, suggesting a duopolistic market structure in relation to time-sensitive passengers. Despite some change in market share, the market structure is not in our view materially different from that before the merger: additional entry on these services would, in principle, be desirable irrespective of the effects of the merger we are considering.

2.98. On the London–Vancouver route, following the merger there has been little change to the level of concentration of OD passengers compared with the previous combined share of BA and Canadian Airlines, while the level of concentration of business scheduled OD passengers has declined.

2.99. On the London–Calgary route, competition has been significantly reduced. There is competition for price-sensitive passengers from the former charter operators and from UK charter operators and we see no significant barriers to entry or expansion in the provision of services to price-sensitive passengers. Competition has, however, been virtually eliminated for time-sensitive passengers between Heathrow and Calgary. In our view, whilst there is sufficient prospect of entry or expansion from other airlines to safeguard the position of price-sensitive passengers, the number of time-sensitive passengers is likely to prove insufficient to attract new entry.

2.100. On the London–Ottawa route, competition has been significantly reduced for price-sensitive passengers and almost eliminated for time-sensitive passengers.

2.101. We have also established that following the merger competition on the London–Canada routes has been made more difficult as a result of two further factors: the prorates introduced by Air Canada, significantly affecting competition for through journeys beyond the main Canadian gateways; and its commission override system.

The effects of the merger

2.102. In the previous section, we considered the change in market structure on individual routes following the merger. On the London–Toronto route, we do not believe the position is significantly different from that prior to the merger. On the London–Calgary and London–Ottawa routes the current market situation is one of concern, as is competition for through journeys beyond the main Canadian gateways. However, in considering the effects of the merger, we have to consider what would have happened in the absence of the merger. As noted in paragraph 2.19, the only meaningful scenario against which to judge the effects of the merger is the financial failure of Canadian Airlines, and its break-up.

2.103. On the London–Calgary route, we believe the loss of competition in services to time-sensitive passengers resulted from the inability of Canadian Airlines to sustain competition with Air Canada. Since, in the event of its financial failure and break-up, there was little prospect of another operator taking on Canadian Airlines' services on these routes, this loss of competition would have occurred irrespective of the merger.

2.104. On the London–Ottawa route, for similar reasons we believe that the loss of competition would have occurred irrespective of the merger.

2.105. As discussed in paragraph 2.56ff, we also believe that the practices of Air Canada toward prorates and commission overrides result from the inability of Canadian Airlines to sustain competition within Canada and cannot be regarded as an effect of the merger per se. As we indicated in paragraph 2.94, we consider that the measures adopted by the Canadian Government did not address these concerns or our other concerns about the loss of competition on the London–Calgary and London–Ottawa routes. These matters should inform the UK Government with regard to the existing bilateral agreement concerning air services between the UK and Canada, and in any future renegotiation of that agreement.

Conclusions on the public interest

2.106. The potential detriments arise irrespective of the merger situations following the failure of Canadian Airlines to sustain competition in the Canadian domestic market or on the Canada–UK routes. We see no evidence to establish that the merger situations we have to consider adversely affect competition, fares, or the level or quality of service on these routes.

2.107. We have therefore concluded that both merger situations we identified in paragraph 2.7—the acquisition by Air Canada during the course of our inquiry of a controlling interest in Canadian Airlines and, prior to that, Air Canada's ability materially to influence CAC and its subsidiary Canadian Airlines—do not operate and may not be expected to operate against the public interest.